Cross-Border Derivatives Update

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1. Presentation

2. Harvard Business Law Review Article:
   “The CFTC’s Cross-Border Guidance for Swaps and Substituted Compliance Regime”

3. Morrison & Foerster Client Alert:
   “CFTC Adopts Uncleared Swaps Margin Rules”

4. Morrison & Foerster Client Alert:
   “Valuing Derivatives in a Bank Bail-In”

5. Morrison & Foerster Client Alert:
   “Collateralising Uncleared Derivatives Trades under EMIR – Draft Regulatory Technical Standards”
Cross-Border Derivatives Update

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Overview of Presentation

• Background regarding cross-border regulation of swaps
• Cleared swaps: the EU-U.S. “Common Approach” to CCPs
• Comparison of U.S. and EU regulations regarding cross-border application of substantive regulatory requirements
• Particular U.S. and EU requirements
  • Clearing
  • Exchange Trading
  • Margin
Background – the G-20 Commitments

• September 2009 - G-20 made a commitment to transparency and safety in the derivatives market place
  “All standardized OTC derivatives should be traded on exchanges […] cleared through central counterparties […] OTC derivatives contracts should be reported to trade repositories”

• As a result, the G-20 jurisdictions have been working on parallel, but not identical, reforms that generally resemble each other but differ in their details, as well as in the timing of their effectiveness

• However, the swaps marketplace has historically been profoundly international

• As a result, the question comes to the forefront: which jurisdiction’s rules will apply to which swaps?
U.S. Statutory Basis for Extraterritoriality

• Dodd-Frank’s provisions for extraterritorial jurisdiction differ somewhat with respect to the CFTC (with respect to swaps) and the SEC (with respect to security-based swaps)
  • CFTC: Under Title VII section 722(d), activities outside the U.S. may be regulated if:
    • they have a direct and significant connection with activities in, or effect on, commerce of the U.S.; or
    • they contravene such rules or regulations as may be prescribed under the Act, necessary or appropriate to prevent the evasion of the relevant provisions of the Act
  • SEC: Under Title VII section 772(c), a person transacting a business in security-based swaps outside the U.S. may be regulated if:
    • such person transacts such business in contravention of such rules and regulations as the SEC may prescribe as necessary or appropriate to prevent the evasion of the relevant provisions of the Act
EU Basis for Extraterritoriality

- Certain provisions of EMIR will apply to extraterritorial derivatives activities, where certain circumstances exist.
- A contract (for a class of derivatives that has been declared to be subject to the clearing obligation) will be compulsorily clearable where it is entered into after a particular date between two entities established outside the EU, where:
  - those entities would be subject to the clearing obligation if they were established in the EU, and
  - the contract has a “direct, substantial and foreseeable effect within the EU”, or
  - the imposition of compulsory clearing is necessary or appropriate to prevent the evasion of any provisions of EMIR.
- “would be subject to the clearing obligation if they were established in the EU” – effectively means that they would be categorised as a “financial counterparty”, or a “non-financial counterparty” with aggregate OTC derivatives positions above the clearing threshold, if they were established in the EU.
EU Basis for Extraterritoriality (cont.)

• “direct, substantial and foreseeable effect” – limited to circumstances where either:
  • one of the parties benefits from a guarantee from a financial counterparty in the EU, if the guarantee:
    • covers all or part of the liability under the relevant OTC contract; and
    • covers liabilities of at least EUR8 billion; and
    • is at least equal to 5% of the aggregate current exposures in OTC contracts of the relevant financial counterparty, or
  • both parties would qualify as financial counterparties if they were established in the EU and enter into the contract through one of their EU branches

• In respect of uncleared OTC derivative contracts, non-EU entities will be subject to those of EMIR’s risk mitigation obligations to which they would be subject if they were established in the EU, where either of the following conditions is met:
  • those contracts have a direct, substantial and foreseeable effect in the EU; or
  • the relevant risk mitigation obligation is necessary or appropriate to prevent the evasion of any part of EMIR
EU Basis for Extraterritoriality (cont.)

• Therefore, subject to satisfaction of one of the above conditions, non-EU entities equivalent to financial counterparties would be subject to obligations in respect of exchange of margin, holding appropriate amounts of capital, timely confirmation of trades, portfolio reconciliation and dispute resolution procedures.

• Non-EU entities equivalent to above-threshold non-financial counterparties would (subject to satisfaction of one of the above conditions) be subject to the same risk mitigation obligations as financial counterparties, except as to the holding of capital, whereas those non-EU entities equivalent to below-threshold non-financial counterparties would be subject only to obligations as regards timely confirmation of trades, portfolio reconciliation and dispute resolution procedures.
“Substituted Compliance” and “Equivalence”

• Simplified somewhat, the rules in the U.S. generally provide that, when a U.S. person is a party to a swap, that swap will be governed by U.S. rules.

• There is no equivalent rule in the EU.
“Substituted Compliance” and “Equivalence” (cont.)

• The U.S. rules set up a possible conflict, however, when the counterparty of a U.S. person is in another jurisdiction, such as the EU
• What happens if the U.S. regulatory agencies require that U.S. substantive rules apply to a swap and the EU regulators require that EU substantive rules apply to a swap, and those substantive rules are inconsistent or conflicting?
• In certain situations involving swaps with some nexus outside of the U.S., the U.S. regulators have determined that “substituted compliance” may apply
• Basic idea of substituted compliance is that a market participant may substitute compliance with a local non-U.S. rule for compliance with a U.S. rule
“Substituted Compliance” and “Equivalence”

• In order for a market participant to comply with non-U.S. rules instead of U.S. rules, the relevant U.S. regulator must determine that the analogous foreign rules are sufficiently comprehensive and comparable to its own rules.

• The language of substituted compliance informs much of the discussion around harmonization.

• Tension between a requirement-by-requirement approach and a “holistic” or “outcome based approach.”
“Equivalence” in EMIR

• Similarly, in the EU, Article 13 of ESMA permits the European Commission to adopt implementing acts, declaring the equivalence of the legal, supervisory and enforcement arrangements of a non-EU country, in respect of the clearing, reporting and risk mitigation provisions of EMIR

• If an implementing act is adopted in respect of a non-EU country, this implies that counterparties to a transaction subject to EMIR shall be deemed to have fulfilled their clearing, reporting and risk mitigation provisions where at least one of the counterparties is established in that non-EU country

• Such an implementing act can be withdrawn if the European Commission, in cooperation with ESMA, concludes that there has been an insufficient or inconsistent application of the equivalent requirements by that non-EU country’s authorities
EU-U.S. “Common Approach” to CCPs

- With respect to cleared swaps, there has been significant progress with respect to international harmonization
- On February 10 of this year, European Commissioner for Financial Stability, Financial Services and Capital Markets Union, Jonathan Hill, and CFTC Chairman Timothy Massad announced a “common approach” regarding requirements for central clearing counterparties (CCPs)
- The common approach to CCPs should help the cleared swaps market to remain unfragmented
- The EU made positive “equivalence” decisions for the regulatory regimes of CCPs in Australia, Hong Kong, Japan and Singapore, Mexico, Canada, South Africa, Switzerland and the Republic of Korea before reaching the agreement with the U.S. on the “common approach”
EU-U.S. “Common Approach” to CCPs

- The EU has postponed several times its deadline for the recognition of U.S. equivalence in respect of CCPs.
- If the EU were to fail to recognize U.S. CCPs, there would come a parade of horribles:
  - U.S. CCPs would not constitute “Qualifying CCPs” for purposes of Basel III risk-weighting.
  - European banks would incur prohibitive costs to clear through U.S. CCPs.
  - U.S. CCPs would have difficulty in maintaining clearing member relationships with EU firms.
  - U.S. CCPs would be ineligible to clear contracts subject to the upcoming EU clearing mandate.
EU-U.S. “Common Approach” to CCPs

• Under the common approach, the European Commission intends to adopt in the near future an equivalence decision with respect to CFTC requirements for U.S. CCPs, which will allow the EU to recognize U.S. CCPs as soon as practicable
• Once recognized by ESMA, U.S. CCPs will continue to provide services in the EU, while complying with CFTC requirements
• With respect to the U.S. rules and substituted compliance, the CFTC staff will propose a determination of comparability with respect to EU requirements
• This will permit EU CCPs to provide services to U.S. clearing members and clients while complying with certain corresponding EU requirements
EU-U.S. “Common Approach” to CCPs

• The European Commission’s proposed determination of equivalence is based on the condition that CFTC-registered U.S. CCPs seeking recognition in the EU confirm that their internal rules and procedures ensure:
  • for clearing members' proprietary positions in exchange traded derivatives, the collection of initial margins that are sufficient to take into account a two day liquidation period;
  • that initial margin models include measures to mitigate the risk of procyclicality; and
  • the maintenance of 'cover 2' default resources, that is, enough loss absorption capacity to cover a simultaneous failure of a CCP’s two largest members
EU-U.S. “Common Approach” to CCPs

- These conditions will not apply with respect to U.S. agricultural commodity derivatives traded and cleared domestically within the U.S.
- This carve out is intended to recognize the nexus of these U.S. contracts with the U.S. economy, the importance of these contracts to U.S. farmers and ranchers and the low degree of systemic interconnectedness of these markets with the rest of the financial system.
- In addition, the European Commission will soon propose the adoption of an equivalence decision under EMIR to determine that U.S. trading venues are equivalent to regulated markets in the EU, providing a level playing field between EU and U.S. trading venues for the purposes of the MIFID I framework. Since compulsory on-exchange trading of derivatives will not be introduced in the EU until MiFID II takes effect, this determination will have more relevance to the determination of which trades are “OTC” for the purpose of determining whether a non-financial counterparty is above or below the clearing threshold.
EU-U.S. “Common Approach” to CCPs

• Before an equivalence decision is adopted by the European Commission, Member State authorities must vote in the European Securities Committee
• Once a decision is adopted, ESMA will proceed to complete the process for recognizing applicant U.S. CCPs, including the execution of a cooperation arrangement with the CFTC, providing for the ongoing sharing of information
• During the recognition process, CFTC-registered U.S. CCPs will continue to benefit from any transitional relief under the Capital Requirements Regulation including any extensions that are granted
EU-U.S. “Common Approach” to CCPs

- On the U.S. side, the CFTC staff will propose a determination of comparability, concluding that a majority of EU requirements are comparable to CFTC requirements.
- This determination will provide a basis for both EU CCPs already registered with the CFTC as derivatives clearing organizations, and those seeking registration, to meet certain CFTC requirements by complying with the corresponding requirements as set forth in EMIR.
- In addition, the CFTC staff will propose to streamline the registration process for EU CCPs wishing to register with it, reflecting these similar requirements.
- This process will be completed within the same timeframe as the process for EU equivalence and recognition of CFTC-registered US CCPs.
EU-U.S. “Common Approach” to CCPs

• The steps required to implement the common approach are expected to be put into place as soon as practicable and in a coordinated manner
• The EU recognizes that EU market participants may wish to use CFTC-registered U.S. CCPs to satisfy their upcoming central clearing obligations under EMIR
• The first phase of clearing obligations for certain interest rate derivative contracts is scheduled to take effect on 21 June 2016
• Market participants may continue to clear these contracts in non-recognized CFTC-registered US CCPs until that date
• The European Commission Services and the CFTC anticipate that CFTC registered CCPs will be in a position to be recognized by that date and the CFTC will work closely with ESMA to facilitate this process
EU-U.S. “Common Approach” to CCPs

- ESMA has recently consulted on the possibility for EU CCPs to apply an alternative standard for client margining
- This would allow EU CCPs to comply with standards similar to CFTC requirements regarding client margining
- Such a change would reduce the possibility for regulatory arbitrage across jurisdictions
- The European Commission Services are of the view that any such alternative should also address the scope for regulatory arbitrage between US and EU standards with respect to margin obligations for clearing members and their affiliates
Status of U.S. Cross-Border Rules

• CFTC issued cross-border “guidance” in July of 2013
  • Was challenged in court and upheld
  • Addresses which substantive rules apply to swaps involving which counterparties
  • “Guidance,” not rules

• SEC has not yet issued comprehensive final rules or guidance
  • In general, the SEC is far behind the CFTC in finalizing and implementing its rules
  • The SEC has not yet finalized its proposed rules regarding which substantive rules apply to swaps involving which counterparties
  • However, the SEC has provided the following:
    • Rules stating which security-based swaps must be “counted” for purposes of security-based swap dealer registration and the de minimis threshold that applies to SBS
    • Definition of U.S. Person
Status of U.S. Cross-Border Rules

- Particular rules regarding margin:
  - Prudential banking regulators have provided final rules regarding margin for cross-border transactions
    - Prudential regulators include the Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency
    - Prudential regulators’ margin rules govern swap dealers that are banks subject to U.S. regulation
  - CFTC has proposed rules regarding margin for cross-border transactions but has not yet finalized them
  - No final SEC margin rules yet, or rules regarding the cross-border application of margin rules
CFTC Cross-Border Guidance

- Divides substantive CFTC regulatory requirements into “Transaction-Level” and “Entity-Level” requirements
- Entity-Level requirements include capital adequacy, chief compliance officer, risk management, and most swap data recordkeeping and swap data repository reporting
- In relation to Entity-Level Requirements, for non-U.S. swap dealers, the CFTC has generally shown broad deference (through substituted compliance determinations) to rules of other jurisdictions
- Transaction-Level Requirements consist of Category A Transaction-Level Requirements (which include clearing, trade execution, swap trading relationship documentation, and real-time public reporting) and Category B Transaction-Level Requirements (the CFTC’s external business conduct standards)
CFTC Cross-Border Guidance

• Transaction-Level requirements – a different story, like a continuum:
  • At one end of the spectrum, Transaction-Level requirements apply to swaps involving
    • a CFTC-registered swap dealer (whether or not a U.S. Person) acting through a U.S. branch or
    • a U.S. Person other than a swap dealer.
  • At the other end of the spectrum, Transaction-Level requirements do not apply (unless one party is a swap dealer acting through a U.S. branch or a U.S. Person) to swaps involving a party that is not a U.S. Person and not otherwise linked to the U.S. as a “guaranteed affiliate” or an “affiliate conduit”
  • With respect to swaps that do not fall at either end of the spectrum, such as swaps involving a CFTC-registered swap dealer acting through a non-U.S. branch, a substituted compliance determination is possible in relation to many Transaction-Level requirements
SEC Cross-Border Rules

- The SEC released proposed (and not yet finalized) rules regarding the cross-border application of its substantive rules in May, 2013
  - Although the details are different, there is a similar pattern, or continuum, as in the CFTC’s cross-border guidance
- In addition, in May, 2014, the SEC released final rules regarding which security-based swaps count toward the security-based swap dealer de minimis registration thresholds
- In February of this year, the SEC also recently released additional set of final rules clarifying that certain SBS arranged, negotiated or executed by personnel within the U.S. will count toward the de minimis thresholds
Harmonization and the CFTC’s Guidance

- The CFTCs’ cross-border guidance appears to contain features that, from the perspective of a non-U.S. regulator, might well complicate attempts at harmonization.
Harmonization and the CFTC’s Guidance (cont.)

• Under the cross-border guidance, many of the CFTC’s substantive rules, including for mandatory clearing and trade (SEF) execution, will apply to any swap involving a U.S. Person (as defined)
  • However, in a transaction between, for example, New York head office of a U.S. swap dealer and the German head office of a German swap dealer, the EU’s rules should presumably apply to the same extent the U.S. rules do
  • If the EU were to take a position parallel to that of the CFTC and require the application of the EU’s rules to a transaction involving an EU swap dealer, the transaction would be governed by both U.S. and EU rules
  • Any material differences between these two sets of rules could be a significant issue for the parties to such a transaction and, by extension, for the swaps market as a whole
Another feature of the CFTC’s cross-border guidance that could frustrate a reciprocal approach is the CFTC’s stance regarding swaps with non-U.S. Persons located within the U.S.

The CFTC has taken the view that the U.S. branch of a non-U.S. swap dealer would be subject to Transaction-Level requirements, including clearing and SEF execution, because of the CFTC’s strong interest in regulating dealing activities occurring within the United States.

However, the CFTC did not recognize an equally strong interest of non-U.S. regulators in regulating the dealing activities of branches of U.S. swap dealers located in their jurisdictions.
Harmonization and the CFTC’s Guidance (cont.)

- With respect to transactions entered into by U.S. swap dealers acting through non-U.S. branches, the CFTC stated that, if such branches faced a U.S. Person (other than the foreign branch of another U.S. swap dealer) in a swap, then the CFTC’s own Transaction-Level Requirements would apply.

- Once again, if a foreign regulator were to take a position parallel to that of the CFTC, requiring that the branches of swap dealers within its geographical jurisdiction adhere to the foreign regulator’s rules, then a transaction could be governed by both U.S. and non-U.S. rules.

- In addition, with respect to such Transaction-Level requirements, the CFTC has stated that, even if a non-U.S. branch of a U.S. swap dealer were facing a non-U.S. Person in a swap, then substituted compliance would apply.
Taking the CFTC’s view of its authority one step further, the CFTC in November 2013 issued a “Staff Advisory” regarding swaps “arranged, negotiated or executed, or executed by personnel or agents of the non-US SD located in the United States”

In the advisory, the CFTC took the position that, because of its supervisory interest in swap dealing activities within the United States, even where a swap is between a non-U.S. branch of a non-U.S. swap dealer and another non-U.S. Person, the CFTC’s Transaction-Level Requirements will apply to the swap if it is “arranged, negotiated, or executed by personnel or agents of the non-U.S. swap dealer located in the United States.”

It appeared that the CFTC would require counterparties to a swap to comply with certain transaction level requirements even if both were foreign and entered into a swap through non-U.S. offices, if one entity employed U.S.-based front office personnel or agents in relation to the swap
Harmonization and CFTC Advisory 13-69 (cont.)

- However, a series of no-action letters have granted relief, currently extended until September 30, 2016 (or any prior date of CFTC action), to non-U.S. swap dealers failing to comply with the Transaction-Level Requirements in relation to swaps with any non-U.S. person
- In addition, the CFTC has issued a request for comment on “whether the Commission should adopt” the advisory “as Commission policy, in whole or in part”
- Recent comments by CFTC Chairman Massad appear to indicate that the CFTC is determining how to amend the advisory
Substituted Compliance Determinations

- CFTC has announced few substituted compliance determinations to date, and none since the end of 2013:
  - On December 20, 2013, the CFTC announced comparability determinations for various entity-level requirements for Australia, Canada, the EU, Hong Kong, Japan and Switzerland
  - However, with respect to transaction-level requirements, the CFTC’s comparability determinations were limited to a few provisions for Japan and the EU
  - No substituted compliance determinations yet with respect to mandatory clearing or trade execution
EU equivalent of U.S. Cross-Border Rules

- There is no EU equivalent of the U.S. Cross-Border Rules
- However, subject to “equivalence” determinations:
  - EU financial counterparties and above-threshold EU non-financial counterparties will always be subject to the obligation to clear a clearable OTC derivative through an EU CCP authorized under EMIR or a non-EU CCP recognized under EMIR, except when facing below-threshold non-financial counterparties or their non-EU equivalents
  - all EU counterparties to derivative contracts have an obligation to report their trades to an EU trade repository authorized under EMIR or to a non-EU trade repository recognized under EMIR, irrespective of whom they are facing
  - certain risk mitigation provisions (confirming trades, portfolio reconciliation) will apply to all EU parties to OTC derivatives, irrespective of whom they are facing, and all of the risk mitigation provisions will apply to EU financial counterparties, whomever they are facing
  - for EU counterparties, the question of which branch they are acting through is irrelevant to all EMIR obligations
Clearing Requirement – EU

• As from 21 June 2016, four classes of interest rate swaps start to become subject to the clearing obligation on a phased basis:
  • basis (float-to=float) swaps denominated in EUR, GBP, JPY and USD
  • plain vanilla (fixed-to=float) swaps denominated in EUR, GBP, JPY and USD
  • forward rate agreements denominated in EUR, GBP and USD
  • overnight index swaps denominated in EUR, GBP and USD

• ESMA has also proposed a clearing obligation for fixed-to=float interest rate swaps and forward rate agreements denominated in certain other European currencies. This has not been adopted yet

• The European Commission has adopted a delegated regulation, specifying two untranched Index CDS (iTraxx Europe Main and iTraxx Europe Crossover) that will become subject to the clearing obligation on a phased basis, starting in early 2017

• ESMA decided not to subject FX non-deliverable forwards to mandatory clearing at the moment, but did not rule out a change to this position in the future, based on future market developments
Clearing Requirement – U.S.

• In the U.S. mandatory clearing has been in effect since it was phased in during 2013
• Section 2(h)(1)(A) of the U.S. Commodity Exchange Act makes it unlawful to engage in any swap that the CFTC requires to be cleared, unless it is submitted to a registered clearing organization for clearing
• The CFTC subjects classes or types of swaps to mandatory clearing by describing them in a clearing determination
• Only one mandatory clearing determination to date, which applies to a broad range of interest rate swaps and many index credit default swaps
  • Largely similar to EU requirements, but also applies to forward rate agreements denominated in JPY and North American untranchsed index CDS
• There has been discussion over whether to require the clearing of FX non-deliverable forwards as well, but not clear when or if NDFs may become subject to mandatory clearing
Clearing Requirements – EU vs. U.S.

- Scope of products: U.S. and EU requirements are generally similar, but CFTC requirements (unlike EU) apply to forward rate agreements denominated in JPY and certain North American untranched index CDS.
- Timing considerations: the EU lags behind the U.S., currently having no contracts subject to mandatory clearing, so substituted compliance would not be applicable.
Clearing Requirements – EU vs. U.S.

• Parties required to clear
  • CFTC has provided an end-user exemption for market participants that are not “financial entities,” meet certain reporting obligations and use the relevant swap or swaps to hedge or mitigate commercial risk
  • EU has no direct equivalent to the CFTC’s end-user exception. The closest equivalent is the categorization of a sub-threshold non-financial counterparty. Essentially this is a person or entity established in the EU, that is not a financial counterparty and that does not have OTC derivatives contracts with an aggregate gross notional value exceeding the relevant clearing threshold. There are different clearing thresholds for different asset types – EUR 1 billion for each of credit and equity derivatives, and EUR 3 billion for each of interest rate, FX and commodity and other derivatives. The non-financial counterparty must aggregate all of its OTC contracts, and those of all other non-financial counterparties within its group. Excluded from these calculations are contracts that are “objectively measurable as reducing risks directly relating to the commercial or treasury financing activity of the non-financial counterparty or of that group. Once a non-financial counterparty exceeds any one of the thresholds, they are considered an above-threshold non-financial counterparty for all purposes of EMIR
Exchange Trading Requirement – EU

- Compulsory exchange trading is mandated by the Markets in Financial Instruments Regulation for centrally cleared derivatives contracts that are considered by ESMA to be sufficiently liquid to be traded only on:
  - regulated markets;
  - multilateral trading facilities;
  - organized trading facilities; and
  - non-EU trading venues in respect of which the European Commission has adopted an equivalence decision for the relevant country (so far no such decisions have been adopted),

  and at least one class of which is actually traded on one of these venues

- ESMA has submitted its draft regulatory technical standards to the European Commission

- However, the implementation date for MiFIR and the MiFID II Directive has just been postponed for a year until January 2018

- This leaves the EU lagging a long way behind the U.S. in this respect
Exchange Trading Requirement – U.S.

- To promote pre-trade price transparency, the Dodd-Frank Act requires that all swaps that are required to be cleared be executed on a designated contract market (DCM) or a swap execution facility (SEF), unless the swap is not available to trade on any DCM/SEF or another clearing exception applies.
- CFTC approved final rules for SEFs in May of 2013 and the exchange trading requirement went into effect in 2014.
- This was one of the rules that was broadly considered to have fragmented the cross-border market.
  - Market participants outside of the U.S. in many cases decided not to trade with U.S. persons in order to avoid the requirement to trade on a SEF.
- Note: because of linkage of clearing requirement to exchange trading requirement, one might question the significance of the U.S.-EU accord on CCPs, standing alone.
Exchange Trading Requirement – U.S.

- CFTC’s core principles and other requirements for SEFs:
  - define a SEF as a trading system or platform that is not a DCM, and in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants (definition excludes single-dealer platforms)
  - require SEFs to comply with a minimum functionality requirement by offering an “Order Book,” an electronic trading facility, trading facility, or trading system or platform in which all market participants have the ability to enter multiple bids and offers, observe or receive bids and offers, and transact on them
  - distinguish between “Required Transactions,” which are required to be cleared and executed on a SEF or DCM, and “Permitted Transactions” not subject to mandatory SEF execution
    - Required Transactions must generally be executed on a system by which market participants send a request for a quote to buy/sell a particular instrument to at least three independent market participants
Exchange Trading Requirement – U.S.

- CFTC’s “Made Available to Trade” ("MAT") rule provides that a swap that is subject to mandatory clearing must be executed on a SEF or DCM only if a SEF or DCM has made the swap “available to trade”
  - After listing, a SEF or DCM may make a MAT determination for a group, category, type or class of swap
  - A MAT determination is then provided to the CFTC, which may review the determination
- Many SEFs submitted MAT determinations to the CFTC in late 2013 or early 2014, and the trade execution requirement went into effect in 2014
Exchange Trading Requirement – U.S.

• Extraterritoriality issue in relation to SEF registration:
  • As noted earlier, as part of the “common approach,” the European Commission will soon propose the adoption of an equivalence decision under EMIR to determine that U.S. trading venues are equivalent to regulated markets in the EU
  • In addition, the CFTC staff will propose to streamline the registration process for EU CCPs wishing to register with it, reflecting these similar requirements
  • The common approach should help to resolve issues arising from the CFTC’s determination, stated in a guidance letter issued in late 2013, that a multilateral swaps trading platform located outside the United States that provides U.S. persons or persons located in the U.S. (such as agents of non-U.S. persons located in the United States) with the ability to trade or execute swaps on or pursuant to the rules of the platform, either directly or indirectly through an intermediary, should register as a SEF or DCM
  • This meant that many multilateral swaps trading platforms outside of the U.S. were, under CFTC guidance, required to register with the CFTC
  • In response, some non-U.S. platforms decided to deny access to U.S. firms and U.S. situated traders of non-U.S. firms rather than register with the CFTC
Exchange Trading Requirements – EU vs. U.S.

• Scope of products:
  • In the EU, the scope of products subject to mandatory exchange trading will be determined by ESMA, based on its assessment of the liquidity of the product.
  • In the U.S., MAT determinations (based in part on liquidity) already cover most of the products that are subject to the CFTC’s clearing determination

• Timing considerations:
  • In the EU, there will be no compulsory trading requirements for derivatives until the MiFID II legislative package becomes effective, which will now not be until January 2018
  • In the U.S., SEF trading has been mandatory since 2014

• Parties required to trade on exchanges:
  • In the EU, the trading obligation will apply to EU financial counterparties and EU above-threshold non-financial counterparties trading with other EU financial counterparties or EU above-threshold non-financial counterparties
  • In the U.S., swaps not subject to clearing based on the end-user exception from the clearing requirement are not required to be traded on SEFs
Background Regarding Margin

- Margin for uncleared swaps was not one of the derivatives markets reforms required by the 2009 Pittsburgh G-20 agreement.
- Dodd-Frank, enacted in 2010, required regulators to draft rules requiring margin for bilateral swaps that will not be cleared at a clearinghouse (cleared swaps, in contrast, are subject to margin requirements imposed by clearinghouses and their members).
- Margin was added to the agreed G-20 reforms in 2011, when the G-20 requested the Basel Committee on Banking Supervision (BCBS) and International Organization of Securities Commissions (IOSCO) to develop, for consultation, consistent global standards for margin requirements.
- As with the other G-20 reforms, margin requirements, though mandated by international agreement, are being implemented at the level of individual jurisdictions.
Background Regarding Margin

• Margin is a significant economic issue that the swap market will need to address in accordance with rules that have only recently become final in the U.S. and are yet to become final in the EU
• Based on the BCBS/IOSCO framework, U.S. regulators have finalized rules for swaps that draw heavily on traditional margin practices in the futures market
• Most significantly, the regulations will require many parties (other than commercial end-users) to provide initial margin, which is intended to account for potential changes in value during the time when a swap is in the process of being terminated
• Under the U.S. and EU rules, initial margin, when required, will be segregated and not subject to rehypothecation or other use – and, as such, a significant new cost for swap dealers and certain other financial entities
• It remains to be seen how the market will respond to the margin requirements, and the extent to which products other than OTC swaps (for example, futures) may increasingly be used in place of OTC swaps
Status of Margin Rules - Europe

• Article 11(3) – Financial Counterparties and above-threshold non-financial counterparties ("in-scope entities") must have risk management procedures that require the timely, accurate and appropriately-segregated exchange of collateral with respect to OTC derivatives entered into on or after 16 August 2012/the date on which the NFC exceeds the threshold

• Various exemptions exist for intragroup transactions

• Currently in-scope entities are forced to apply their own standards when developing their risk management procedures. The 3 European Supervisory Authorities were mandated to develop regulatory technical standards to specify the levels and types of collateral and segregation arrangements required to comply with Article 11(3)

• The ESAs have consulted on draft RTS, most recently in June 2015, and these were just finalised on 8 March 2016. They will now need to be adopted by the European Commission, in order to become effective
Status of Margin Rules – Europe (cont.)

- The RTS include requirements to (1) collect variation margin on a daily basis to cover the mark-to-market exposure of counterparties during the life of an existing trade and (2) collect initial margin upon inception of the trade. Only certain assets may be posted for this purpose and a list of eligibility criteria must be satisfied. Once collected, the margin must be segregated from proprietary assets in the books and records of the custodian or third-party that is holding it. Initial margin also cannot be rehypothecated.

- The collateralisation of uncleared trades will be phased in from 1 September 2016. However, only the largest market participants will be subject to initial and variation margin collection requirements from that date (i.e., only those that trade non-centrally cleared derivatives in excess of €3 trillion in aggregate average notional amount). Smaller market participants will be subject to variation margin requirements only from 1 March 2017 and subject to initial margin requirements on a phased basis, with counterparties who trade non-centrally cleared derivatives in excess of €8 billion being subject to the initial margin requirements by September 2020.
Draft Margin Rules – Europe

• As with other risk-mitigation requirements, non-EU entities will only be directly obligated by the requirements of the RTS, to the extent that they trade non-cleared OTC derivatives with other non-EU entities and such transactions have a “direct, substantial and foreseeable effect in the EU”. However, non-EU entities (that would be financial counterparties or above-threshold non-financial counterparties if they were established in the EU) and that trade with in-scope entities will still need to post collateral and put collateralisation procedures in place, in order to allow the in-scope entities to comply with the requirements.

• Parties will have an option to apply a minimum transfer amount of up to EUR500,000 when exchanging initial or variation margin.

• Acceptable collateral covers a wide range of assets, including sovereign bonds, covered bonds, specific securitization bonds, corporate bonds, gold and equities. They are subject to eligibility criteria and certain conditions as to liquidity and risk concentration limits.
Draft Margin Rules – Europe (cont.)

• In-scope entities will be subject to the compulsory margin requirements. Below-threshold non-financial counterparties and non-EU entities will not (except in respect of trades with other non-EU entities, that have a direct, substantial and foreseeable effect in the EU)

• When facing below-threshold non-financial counterparties (and their non-EU equivalents) an in-scope entity is permitted not to demand initial or variation margin. However, it will be required to when facing non-EU entities equivalent to above-threshold non-financial counterparties

• An in-scope entity is not required to collect initial margin where the total amount of margin to be exchanged between the two counterparties at an entity level or group level is equal to or less than EUR 50 million, or where either party belongs to a group which has an aggregate average notional amount of uncleared derivatives below EUR8 billion

• Initial margin can be waived for FX physically settled swaps/forwards, or on the exchange of principal on a currency swap

• Certain margin exemptions apply in respect of derivatives associated with covered bonds
An in-scope entity is not required to post any margin for a contract with an entity in a jurisdiction where the legal enforceability of the netting arrangements, or the effectiveness of the margin segregation arrangements, cannot be confirmed.

For a contract with such an entity, no margin needs to be posted or collateral by the in-scope entity where legal reviews conclude that collecting collateral from such entity is not possible (subject to such contracts of the in-scope entity in aggregate not exceeding 2.5% of all its OTC contracts, measured by outstanding notional amounts).

Written trading documentation, covering all material terms of the trading relationship, must be put in place between the counterparties prior to or contemporaneously with entering into uncleared derivatives. The material terms include payment/delivery obligations, events of default and netting. An in-scope entity must perform an independent legal review of the enforceability of the netting arrangements.
Draft Margin Rules – Europe (cont.)

- Variation margin must be collected on a daily basis, based on mark-to-market valuation
- Valuations can be made on a net basis where an appropriate netting agreement is in place and its legal enforceability confirmed at least annually by an independent legal review
- Initial margin will be calculated based either on a Standardised Method set out in the draft regulatory technical standards or via the use of an initial margin model, which meets required criteria detailed in the RTS, which can be developed by the counterparties or a third party
- Initial margin must be segregated from proprietary assets of the custodian holding it and from other proprietary assets of the collateral owner and, in addition, individual segregation must be offered to the posting counterparty. Rehypothecation of initial margin is prohibited – this is a stricter approach than that proposed by BCBS/IOSCO in their margin standards. Cash initial margin must be deposited with a custodian that is not in the same group as either counterparty, or with a central bank
- Intragroup transactions can be exempted from the margin requirements if the parties’ risk management procedures are sound and robust and there are no legal or practical impediments to the transfer of funds or repayment of liabilities between the parties
- Initial margin can be waived, as from January of any calendar year, where either of the parties (or their respective groups) has uncleared contracts with an aggregate month-end average notional amount for March, April and May of the preceding year, of less than EUR 8 billion
- For this purpose, intragroup uncleared contracts are to be included in the calculation, but only once
Status of Margin Rules – U.S.

- Last October, the Prudential Regulators issued final rules for swap entities subject to their supervision (essentially swap dealers, major swap participants, security-based swap dealers and major security-based swap participants that are banks)
- In addition, last December, the CFTC adopted final rules to impose margin requirements on uncleared swaps entered into by swap dealers and major swap participants subject to CFTC regulation, referred to as “Covered Swap Entities” or “CSEs”
- The CFTC also adopted an interim final rule to exclude from margin requirements most uncleared swaps that swap entities enter into with commercial end users, financial institutions with $10 billion or less in total assets, and certain other entities, consistent with the requirements of the Business Risk Mitigation and Price Stabilization Act of 2015
Status of Margin Rules – U.S. (cont.)

• Both sets of rules become effective on April 1, 2016, with a phased-in compliance schedule beginning in September 2016
• Even though the September date applies only to the largest financial institutions, it is not clear the market is going to be able to meet the stated timing
• Although the CFTC and prudential regulator rules are largely the same, they do have a few material differences
Overview of the Final U.S. Rules

• In general, the CFTC’s and Prudential Regulators’ Rules will:
  • Require swap entities, subject to a $50 million threshold, to bilaterally exchange “initial margin” with other swap entities and with a broad range of “financial end users” whose use of uncleared swaps meet a notional amount-based threshold (“material swaps exposure”), all such initial margin to be segregated with a custodian (not affiliated with either counterparty) and generally not subject to rehypothecation or other use by the custodian;
  • Permit the calculation of initial margin by means of either a model-based method or a table-based method;
Overview of the Final U.S. Rules

• Impose a significantly higher initial margin requirement on uncleared swaps as compared to cleared swaps by requiring that initial margin models use a 10 business day closeout horizon for most uncleared swaps as opposed to a 5 business day horizon for most cleared swaps in order to “incentivize clearing”; and

• Require swap entities to exchange “variation margin” with swap entities and with a broad array of financial end users (without regard to the existence of material swaps exposure) without any threshold.
Scope of the Final U.S. Rules

• Under both sets of rules, a CSE will not be required to collect or post specified amounts of initial or variation margin on swaps with counterparties that are not Swap Entities or “financial end users” – essentially commercial end-users

• The final rules contains a “financial end user” definition that lists numerous types of entities, including banks, broker-dealers, investment companies, insurance companies, commodity pools and ERISA plans

• Expressly excluded from the financial end user definition are sovereign entities (central governments or an agency or department thereof) and multilateral development banks
Financial End Users with Material Swaps Exposure

• The threshold for determining whether a financial end user has “material swaps exposure” has been increased under the CFTC’s and Prudential Regulators’ final rules from $3 billion to $8 billion of average daily aggregate notional amount of swaps activity over a 3-month period (determined by reference to the swaps activity of the financial end user and its affiliate(s)), which is more closely aligned with the BCBS-IOSCO Framework

• This change will reduce the number of entities from which swap entities must post and collect initial margin, which is required under the rules for swaps between swap entities and financial end users with material swaps exposure

• It will also level the playing field between swap entities subject to U.S. rules and those subject to rules of foreign jurisdictions, such as the European Union and Japan, which have more closely followed the BCBS-IOSCO Framework
Eligible Collateral

• The CFTC’s and Prudential Regulators’ final rules also expand the types of eligible collateral for initial and variation margin in comparison with previous proposals.

• Initial margin is intended to secure potential future exposure -- that is, adverse changes in value that may arise during the period of time when a swap or group of swaps is being closed out -- and is in addition to variation margin, which corresponds to changes in mark-to-market value of a swap.

• Under the final rules, eligible collateral types for Initial Margin include U.S. Treasuries, GSE securities, securities issued by BIS, ECB, IMF and MDBs, publicly traded debt (other than asset-backed securities), publicly-traded equities in certain indices and gold, but not securities issued by the pledgor or its affiliate or banks and similar entities.
Eligible Collateral

- Variation Margin may include major currencies (defined in the final rules) in addition to U.S. dollars and the currency of settlement.
- In addition, for swaps between a covered swap entity and a financial end user (but not for swaps between swap entities), the final rules permit non-cash collateral eligible to be used for initial margin to serve as variation margin.
- This change from previous proposals is significant for certain financial entities, such as insurance companies, that hold significant reserves of bonds and other securities and commented that the restriction to cash-only variation margin would reduce their investment returns.
Approval of Initial Margin Models

• Both sets of U.S. final rules impose stringent regulatory requirements on initial margin models, including:
  • Written approval of the relevant regulator for use of initial margin models,
  • Demonstration on an ongoing basis that the model satisfies all of the requirements under the rules, and
  • Prior notice to the relevant regulator before making changes to the model or its assumptions.
Eligible Master Netting Agreements (EMNAs)

- The CFTC’s and Prudential Regulators’ final rules permit counterparties to document pre- and post-compliance date swaps as separate portfolios for netting purposes under the same EMNA covered by separate credit support annexes.
- Accordingly, netting portfolios that contain only uncleared swaps entered before the applicable compliance date are not subject to the final rules.
- EMNAs, as under the previous proposals, are subject to a requirement that a swap entity conduct sufficient legal review to 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.
- Although unqualified legal opinions are not required, the legal review must be in writing.
Phased-in Compliance

- The final rules adopt the delayed phase-in schedule announced by BCBS/IOSCO in March 2015, which delays the beginning of implementation of initial margin and variation margin requirements until September 1, 2016.
- Variation margin:
  - scheduled phase-in on September 1, 2016 where both the covered swap entity combined with all its affiliates and its counterparty combined with all its affiliates have an average daily aggregate notional amount that exceeds $3 trillion.
  - scheduled phase-in on March 1, 2017 for variation margin for any other covered swap entity with respect to covered swaps with any other counterparty.
- Initial margin: phased-in implementation depending upon swaps average daily aggregate notional amounts of the covered swap entity and its affiliates, and its counterparties and their affiliates, starting from September 1, 2016 (for entities with the largest average daily aggregate notional amount) through September 1, 2020.
Margin – Cross-Border Application

- Prudential Regulators’ final rules contain provisions governing the cross-border application of the margin rules, while the CFTC has proposed a separate rulemaking, not yet finalized, to address cross-border application.
- Prudential Regulators’ final rules exempt from margin requirements swaps between foreign swap entities (but not their U.S. branches or offices) and other non-U.S. entities (but not their U.S. offices or branches).
- Exemption is not available where either party’s obligations are guaranteed by a U.S. entity, a U.S. branch, or a foreign swap entity that is a subsidiary of a U.S. entity.
Margin – Cross-Border Application

• Substituted compliance (i.e., compliance with non-U.S. rules rather than U.S. rules) may be available for a foreign bank, U.S. branch or agency of a foreign bank, or an entity that is a foreign subsidiary of a depository institution

• Substituted compliance would not be available if the swap is guaranteed by a U.S. entity

• Substituted compliance is available only if the Prudential Regulators have made a comparability determination for the other jurisdiction whose rules would apply to the uncleared swap
Margin – Cross-Border Application

- CFTC’s proposed rules for cross-border application of margin rules contain intriguing disparities from the CFTC’s cross-border guidance
  - Increased scope for potential substituted compliance determinations
  - Narrowing definition of “U.S. Person”
  - Narrowing definition of “guarantee”

- These changes may indicate that the CFTC may be willing to step back from certain problematic aspects of its cross-border guidance
Margin – Cross-Border Application

- Increased scope for potential substituted compliance determinations
  - Under CFTC’s cross-border guidance, transactions between a non-U.S. dealer and a U.S. person are subject to the CFTC’s rules (although substituted compliance may apply to transactions between the non-U.S. dealer and the foreign branch of U.S. swap dealer)
  - However, under the proposed cross-border rules applicable to margin requirements, substituted compliance could apply to transactions between a non-U.S. swap dealer and most U.S. persons (other than U.S. swap dealers)
  - The CFTC is proposing to make element-by-element determinations as to comparability, and could make substituted compliance determinations for some, but not all, of a foreign jurisdiction’s margin requirements
Margin – Cross-Border Application

• Narrowed definition of “U.S. Person” for purposes of margin requirements
  • Deletion of “includes, but is not limited to” at beginning of definition
  • Provides greater legal certainty
  • Deletion of investment vehicles majority-owned by U.S. persons

• Narrowed definition of “guarantee”
  • Guarantee is defined specifically as an arrangement in which a party to a swap has a right of recourse against a U.S. person to receive or otherwise collect payments from the U.S. person in connection with the non-U.S. person counterparty’s payment obligations under the swap
  • Narrower definition than in cross-border guidance
Questions?

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THE CFTC’S CROSS-BORDER GUIDANCE FOR SWAPS AND SUBSTITUTED COMPLIANCE REGIME

James Schwartz∗

The derivatives market was seen as having contributed substantially to the financial crisis of 2007–08.† This led to efforts to regulate derivatives in many of the countries in which their use was commonplace.‡ Historically, the swaps market consisted primarily of bilateral transactions agreed upon by telephone or electronic messages, which, in the absence of any reporting or clearing requirement, remained known only to the two principals.§ At a September 2009 summit in Pittsburgh, however, G-20 leaders agreed in concept to wholesale reforms.¶ These reforms included the requirements that by the end of 2012, "all standardized OTC [over-the-counter] derivative contracts should be traded on exchanges or electronic trading platforms[] where appropriate," "cleared through [a] central counterpart[y]" standing between the two original parties, and "reported to [a] trade repotpository[]."∥

The G-20’s original timeframe did not hold, and today, almost a year after the G-20’s 2012 year-end target date, implementation of the contemplated reforms remains problematic.¶ Many of the delays reflect issues on the national level—mainly that the de-

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¶ See Leaders’ Statement, supra note 2.
∥ Leaders’ Statement, supra note 2.

See, e.g., JAMES K. JACKSON & RENA S. MILLER, CONG. RESEARCH SERV., COMPARING G-20 REFORM OF THE OVER-THE-COUNTER DERIVATIVES MARKETS (2013),
derivatives market is large, complex, and not especially familiar to many policymakers. However, beyond the need for action at the national level, the regulation of the swaps market, in which transactions between counterparties in wide-ranging jurisdictions have long been routine, requires international coordination and cooperation. If this were lacking, the consequences could include regulatory arbitrage, outsized compliance costs for, or incomplete compliance by, market participants, the fracturing of liquidity among different jurisdictions, and perhaps even political tensions.

The most aggressive regulator of the swaps market to date has been the U.S. Commodity Futures Trading Commission (CFTC), the primary U.S. regulator of derivatives. The CFTC is empowered to regulate the swaps market under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The CFTC’s rules are significantly closer to being implemented than those of many regulators outside the U.S. As a result of the CFTC’s guidance regarding the extraterritorial application of


As the CFTC has noted, “many foreign jurisdictions have been implementing OTC derivatives reforms in an incremental manner,” and “because many jurisdictions are in the process of finalizing and implementing their derivatives reforms incrementally,” the CFTC’s determinations, discussed infra text
its regulations and the timeframe that the CFTC has set for implementation of that guidance, December 21 of this year may be a key date for many market participants. On that day, according to the CFTC’s current timetable, many of the CFTC’s rules may become applicable to many transactions involving U.S. counterparties acting through non-U.S. offices or non-U.S. swap dealers registered with the CFTC by reason of their substantial U.S.-facing swap activities.

Under the terms of the CFTC exemptive order issued on July 22, 2013, many such market participants are exempted from compliance with a number of the CFTC’s rules until the earlier of December 21, 2013 or thirty days following the issuance of an applicable substituted compliance determination. As detailed below, a substituted compliance determination is an assessment by the CFTC that the relevant foreign jurisdiction’s rules are sufficiently comprehensive and comparable to the CFTC’s own rules to be followed in lieu of the CFTC’s rules.

The CFTC’s timeframe, and the uncertain prospects of such substituted compliance determinations, have put many market participants in an uncomfortable position.

accompanying notes 38–50, as to which foreign rules are sufficiently comprehensive and comparable to the CFTC’s own rules “may need to take into account the timing of regulatory reforms that have been proposed or finalized, but not yet implemented.” Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations, 78 Fed. Reg. 45,292, 45,343–44 (July 26, 2013) (to be codified at 17 C.F.R. § 1). For an analysis of one area in which there is a significant difference in timing between U.S. rules and analogous foreign rules, see James E. Schwartz, Marissa N. Golden & Robert J. Dilworth, First Steps on the Path Forward, 32 INT’L FIN. L. REV. 36, 36–37 (2013), available at http://www.iflr.com/Article/3247985/The-path-forward-for-EU-US-derivatives-regulation.html (analyzing the status of the trade execution mandate in the U.S. and the EU, and noting that while the CFTC’s mandate will be in effect shortly, the EU’s is not expected to be in place until possibly as late as 2016).


See Exemptive Order Regarding Compliance With Certain Swap Regulations, 78 Fed. Reg. 43,785, 43,794–95 (July 22, 2013) (stating that numerous requirements for certain non-U.S. market participants and certain non-U.S. branches of U.S. swap dealers will go into effect on the earlier of December 21, 2013 or 30 days after the issuance of an applicable substituted compliance determination).

See id.

See id.

See id. at 43,789.

Even close followers of regulatory matters could be forgiven for not recognizing the words “substituted compliance” when the CFTC used and defined the term in its 2012 proposed interpretive guidance regarding cross-border matters. See Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act, 77 Fed. Reg. 41214, 41229 (proposed July 12, 2012). The term appears to have its origins in a seminal 2007 article in the Harvard International Law Journal, in which the authors argued that foreign stock exchanges and broker-dealers should be able to provide services in the United States “based on their compliance with substantively comparable foreign securities regulations and laws and supervision by a foreign securities regulator with oversight powers and a regulatory and enforcement
Because foreign swaps regulations are generally in a less advanced state than the CFTC’s own rules, the extent to which substituted compliance determinations may even be possible by December 21 is not entirely clear. Where the corresponding non-U.S. rules are in place, it is unclear whether the CFTC will actually make substituted compliance determinations related to those rules. Where the corresponding foreign rules are not yet in place, these could come into effect shortly after December 21. If the CFTC on December 21 requires compliance with U.S. rules, this could mean that market participants will be required to comply with both sets of rules. Moreover, the CFTC’s cross-border guidance contemplates requirement-by-requirement determinations on comparability of non-U.S. swaps regulatory regimes. This mix-and-match approach makes it likely that many market participants will be required to comply both with certain (as yet unspecified) elements of the CFTC’s rules and certain (as yet unspecified) elements of non-U.S. regulatory regimes.

Issues in the cross-border market brought about by the CFTC’s mandatory clearing requirement, which went into effect on October 9 of this year for many market participants, indicate that a significant delay in substituted compliance determinations could be the worst outcome for the U.S. swaps market. Upon the CFTC’s clearing requirement becoming effective, the absence of a substituted compliance determination with respect to clearing prompted certain non-U.S. market participants to avoid dealing with U.S. swap dealers. This has moved swap trading activities with non-U.S. market participants into non-U.S. affiliates. A further, related concern that may be limiting trading by swap dealers through their non-U.S. branches, in the absence of a substituted compliance determination, is that if transactions entered into by such branches are subject


17 See, e.g., Anish Puaar, EU Firms Forced to Take Action to Avoid US Clearing Rules, FINANCIAL NEWS (October 10, 2013), http://www.efinancialnews.com/story/2013-10-10/eu-firms-forced-to-take-action-to-avoid-us-clearing-rules?ea9c8a2de0ee111045601ab04d673622 (“[S]ome European buyside firms are not prepared to clear their swap trades, leading them to either switch to US banks’ European entities or stop trading with them altogether.”).
18 See id.
to mandatory clearing, they may soon also be subject to U.S. rules which in certain cases will likely require execution on a swap execution facility.\textsuperscript{19}

The CFTC’s approach to cross-border matters is complex and nuanced. It divides the CFTC’s requirements into two separate categories: Transaction-Level Requirements and Entity-Level Requirements.\textsuperscript{20} It then splits each of these categories into two subcategories.\textsuperscript{21} The Transaction-Level requirements are split into Category A Transaction-Level Requirements (which include clearing and swap processing, trade execution, swap trading relationship documentation, and real-time public reporting of swap data) and Category B Transaction-Level Requirements (which consist of the CFTC’s external business conduct standards).\textsuperscript{22} Similarly, the Entity-Level Requirements are divided into First Category Entity-Level Requirements (which include capital adequacy, chief compliance officer, risk management, and most swap data recordkeeping) and Second Category Entity-Level Requirements (which include, among others, swap data repository reporting and reporting for large traders of swaps linked to certain commodities).\textsuperscript{23}

The CFTC’s regime, with respect to the Transaction-Level Requirements, may be summarized—albeit in a vastly simplified manner—as a continuum.\textsuperscript{24} At one end of the spectrum such requirements will apply to swaps involving a CFTC-registered swap dealer (whether or not a U.S. Person\textsuperscript{25}) acting through a U.S. branch or a U.S. Person

\textsuperscript{19} The Dodd-Frank Act amended the Commodity Exchange Act, 7 U.S.C. §§ 1–27f (2012), to provide that swaps that the CFTC subjects to mandatory clearing must be executed on either a swap execution facility or a designated contract market, unless no swap execution facility or designated contract market makes the swap available to trade. See Dodd-Frank Act at § 723(a)(8); 7 U.S.C. § 2(h)(8). Mandatory execution on a swap execution facility for certain transactions is expected to commence in the near future, as swap execution facilities have started submitting “made available to trade” determinations, which the CFTC will consider pursuant to its rules. See Process for a Designated Contract Market or Swap Execution Facility To Make a Swap Available to Trade, Swap Transaction Compliance and Implementation Schedule, and Trade Execution Requirement Under the Commodity Exchange Act, 78 Fed. Reg. 33,606 (June 4, 2013) (to be codified at C.F.R. pts. 37 and 38); Provisions Common to Registered Entities, 76 Fed. Reg 44,776, 44,793-96 (July 27, 2011) (to be codified at C.F.R. pt. 40); Silla Brush, Javelin Files to Trade Interest-Rate Swaps, Spurring SeF Shift, BLOOMBERG (October 19, 2013), http://www.bloomberg.com/news/2013-10-19/javelin-files-to-trade-interest-rate-swaps-spurring-sef-shift.html.


\textsuperscript{21} See id. at 45,335–36.

\textsuperscript{22} See id. at 45,336.

\textsuperscript{23} See id. at 45,335–36.

\textsuperscript{24} See id. at 45,369 apps. D & E.

\textsuperscript{25} The CFTC’s cross-border guidance defines a U.S. Person “generally to include, but not be limited to: (i) Any natural person who is a resident of the United States; (ii) any estate of a decedent who was a resident of the United States at the time of death; (iii) any corporation, partnership, limited liability company, business or other trust, association, joint-stock company, fund or any form of enterprise similar
other than a swap dealer. Contrariwise, at the other end of the spectrum, such requirements will not apply (unless one party is a swap dealer acting through a U.S. branch or a U.S. Person) to swaps involving a party that is not a U.S. Person and not otherwise linked to the U.S. as a “guaranteed affiliate” or an “affiliate conduit.” With respect to swaps that do not fall at either end of the spectrum, such as swaps involving a CFTC-registered swap dealer acting through a non-U.S. branch, a substituted compliance determination is possible in relation to many such requirements. With respect to the Entity-to any of the foregoing (other than an entity described in prongs (iv) or (v), below) (a ‘legal entity’), in each case that is organized or incorporated under the laws of a state or other jurisdiction in the United States or having its principal place of business in the United States; (iv) any pension plan for the employees, officers or principals of a legal entity described in prong (iii), unless the pension plan is primarily for foreign employees of such entity; (v) any trust governed by the laws of a state or other jurisdiction in the United States, if a court within the United States is able to exercise primary supervision over the administration of the trust; (vi) any commodity pool, pooled account, investment fund, or other collective investment vehicle that is not described in prong (iii) and that is majority-owned by one or more persons described in prong (i), (ii), (iii), (iv), or (v), except any commodity pool, pooled account, investment fund, or other collective investment vehicle that is publicly offered only to non-U.S. persons and not offered to U.S. persons; (vii) any legal entity (other than a limited liability company, limited liability partnership or similar entity where all of the owners of the entity have limited liability) that is directly or indirectly majority-owned by one or more persons described in prong (i), (ii), (iii), (iv), or (v) and in which such person(s) bears unlimited responsibility for the obligations and liabilities of the legal entity; and (viii) any individual account or joint account (discretionary or not) where the beneficial owner (or one of the beneficial owners in the case of a joint account) is a person described in prong (i), (ii), (iii), (iv), (v), (vi), or (vii).” Id. at 45,316–17.

26 See id. at 45,369 apps. D & E.
27 See id. at 45,350 n.513.
28 See id. at 45,369 apps. D & E.
29 A “guaranteed affiliate” is a “non-U.S. person that is an affiliate of a U.S. person and that is guaranteed by a U.S. person.” Id. at 45,318.
30 See id. at 45,369 apps. D & E. The CFTC has not precisely defined “affiliate conduit” but has stated that certain factors are relevant to the consideration of whether a non-U.S. Person constitutes an affiliate conduit. See id. at 45,369 app. D n.1. Such factors include "whether (i) the non-U.S. person is majority-owned, directly or indirectly, by a U.S. person; (ii) the non-U.S. person controls, or is under common control with the U.S. person; (iii) the non-U.S. person, in the regular course of business, engages in swaps with non-U.S. third party(ies) for the purpose of hedging or mitigating risks faced by, or to take positions on behalf of, its U.S. affiliate(s), and enters into offsetting swaps or other arrangements with such U.S. affiliate(s) in order to transfer the risks and benefits of such swaps with third-party(ies) to its U.S. affiliates; and (iv) the financial results of the non-U.S. person are included in the consolidated financial statements of the U.S. person." Id.
31 See id. at 45,369 app. D. Substituted compliance does not apply with respect to the external business conduct rules that constitute the Category B Transaction-Level Requirements. See id. at 45,369 app. E. This may be partly because such rules, which require dealers in certain transactions to provide pre-trade and daily mid-market marks, and, upon request, scenario analyses, are not expected to have analogs in many non-U.S. jurisdictions. See Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties, 77 Fed. Reg. 9,734 (February 17, 2012) (to be codified at 17 C.F.R. pts. 4 and 23).
Level Requirements, for U.S. dealers, such requirements will apply, and for non-U.S. CFTC-registered swap dealers, substituted compliance determinations will be possible for many such requirements.  

On its face, this approach has a certain logic to it—the more closely linked to the U.S. a counterparty or transaction is, the more likely it is that the CFTC’s rules or similar rules, by way of substituted compliance, should apply. In practice, however, the approach seems likely to cause significant issues in the absence of substantial and close coordination among regulators—which, to date, does not appear overly abundant.

These issues can be illustrated using the first cross-border example above, a transaction involving a U.S. swap dealer acting through a U.S. branch. If the swap were transacted between, for example, the New York head office of a U.S. swap dealer and the Paris head office of a French swap dealer, the EU’s rules should presumably govern the transaction to the same extent the U.S. rules do. If the EU were to take a position parallel to that of the CFTC and require the application of the EU’s rules to a transaction involving an EU swap dealer, the transaction would be governed by both U.S. and EU rules. Any material differences between these two sets of rules could be a significant issue for the parties to such a transaction and, by extension, for the swaps market as a whole.

Even in this relatively straightforward case, some understanding among relevant regulators with regard to cross-border swaps would seem highly desirable. The genius of the CFTC’s approach is that, by implementing its rules first and, by means of substituted compliance determinations, setting a bar for other regulators to reach, it has claimed the power to shape significantly discussions in foreign jurisdictions regarding the substance of swaps regulations. On the other hand, by making its own rules without agreements from other regulators and then delaying compliance dates, the CFTC is putting pressure on other regulators to fall into line to avoid causing conflict. Given the need for cooperation, this approach seems incongruous and even slightly imperious. There is a distinct lack of an institutional framework for making international regulatory swaps deter-


33 Even with regard to the EU, one of the only foreign regulators with which the CFTC has appeared to have tangibly productive discussions, see infra n.51–53 and accompanying text, the lack of a detailed agreement between regulators is reportedly harming the negotiation of a U.S.-EU free trade agreement. Luke Baker & Stephen Adler, Derivatives Dispute Harming EU-U.S. Free-Trade Talks, REUTERS (October 29, 2013), http://uk.reuters.com/article/2013/10/29/uk-eu-us-regulation-idUKBRE99S0G220131029.


35 See id.
minations,\textsuperscript{36} in the absence of which the CFTC contemplates that foreign regulators, industry groups and even individual market participants may request a substituted compliance determination.\textsuperscript{37}

Even for requirements in which substituted compliance is possible, the CFTC’s guidance is unclear. It offers scant insight into whether the CFTC will in fact make a substituted compliance determination, and, if it does make such a determination, what conditions it may impose on market participants seeking to rely on such determination. In order for a party to a swap to substitute compliance with the requirements of a non-U.S. jurisdiction for compliance with the CFTC’s own requirements, the CFTC must determine that the foreign jurisdiction’s requirements “are comparable with and as comprehensive as the corollary area(s) of regulatory obligations encompassed by the Entity- and Transaction-Level Requirements.”\textsuperscript{38} However, they need not be "identical requirements to those established under the Dodd-Frank Act.”\textsuperscript{39} In cases where the CFTC does not find foreign laws and regulations to merit substituted compliance, the relevant non-U.S. Person or foreign branch of a U.S. Person “may be required to comply" with the applicable CFTC regulations.\textsuperscript{40}

The CFTC may consider both swap-specific regulations of the relevant foreign regulator and other provisions that may “achieve comparable and comprehensive regulatory objectives as the Dodd-Frank Act requirements, but on a more general, entity-wide, or prudential, basis.”\textsuperscript{41} Moreover, the CFTC may vary its approach depending on the particular foreign jurisdiction.\textsuperscript{42} In certain cases it may seek to influence the contents of foreign regulations by “coordinating with the foreign regulators in developing appropriate regulatory changes or new regulations, particularly where changes or new regulations already are being considered or proposed by the foreign regulators or legislative bodies.”\textsuperscript{43} In other cases, the CFTC “may include conditions that take into account timing and other

\textsuperscript{36} See id. at 386.
\textsuperscript{38} Id. at 45,342.
\textsuperscript{39} Id. at 45,342–43. “In evaluating whether a particular category of foreign regulatory requirement(s) is comparable and comprehensive to the applicable requirement(s) under the [Commodity Exchange Act] and Commission regulations, the Commission will take into consideration all relevant factors, including but not limited to, the comprehensiveness of those requirement(s), the scope and objectives of the relevant regulatory requirement(s), the comprehensiveness of the foreign regulator’s supervisory compliance program, as well as the home jurisdiction’s authority to support and enforce its oversight of the registrant.” Id. at 45,343.
\textsuperscript{40} Id. at 45,344.
\textsuperscript{41} Id. at 45,343.
\textsuperscript{42} See id.
\textsuperscript{43} Id. at 45,343–44.
issues related to coordinating the implementation of reform efforts across jurisdictions” or otherwise “include in its substituted compliance determination a description of the means by which certain swaps market participants can achieve substituted compliance within the construct of the foreign regulatory regime.”

The CFTC does not intend to make substituted compliance determination with respect to foreign regulations as a whole, but instead with respect to particular foreign regulations. Partly because “many foreign jurisdictions” are in the process of implementing derivatives market reforms “in an incremental manner,” a “comparability analysis will be based on a comparison of specific foreign requirements against specific” provisions of the Dodd-Frank Act and CFTC regulations for each of the categories of regulatory obligations for which substituted compliance may be available. As a result, the swap counterparties to whom substituted compliance may apply will likely be expected to comply with a mixture of U.S. and non-U.S. regulations.

At the same time, however, the CFTC, somewhat puzzlingly, has stated that it expects to “rely upon an outcomes-based approach to determine whether these requirements achieve the same regulatory objectives of the Dodd-Frank Act.” In this context, “outcomes-based” is often understood to refer not to what regulations state, but instead to the actual consequences that they cause. It is not clear why an outcomes-based approach would necessitate a requirement-by-requirement review such as the CFTC contemplates. The SEC, in contrast to the CFTC, stated in its proposed cross-border rules that it would not focus on “a rule-by-rule comparison” but instead “on regulatory outcomes” with a “holistic approach.”

If the CFTC guidance regarding substituted compliance sounds vague enough to support whatever ad hoc arrangement the regulator believes is warranted in any particular case, perhaps that is exactly the point. A commitment to the substituted compliance regime did not prevent the CFTC from agreeing to another approach entirely just days be-

44 Id. at 45,343.
45 Id. at 45,344.
46 See id. at 45,343.
47 Id. at 45,343–44.
48 Id. at 45,342.
49 See Ellig & Shadab, supra note 14, at 282 (“Outcomes are the actual benefits created, or harms avoided, for citizens. . . . [R]egulations issued are outputs that may affect outcomes, but they are not outcomes.”).
fore the release of its cross-border guidance. In one of the relatively few concrete signs of cooperation with foreign regulators, the CFTC and EU authorities agreed in July of 2013 to an understanding known as the “path forward.” In that understanding, they agreed to a “stricter-rule-applies” approach with regard to mandatory clearing, one of the fundamental reforms sought by the G-20. This approach, not referenced in the CFTC’s cross-border guidance, would be applicable “where exemptions from mandatory clearing would exist in one jurisdiction but not in the other.” Although this approach may indeed “prevent loopholes and any potential for regulatory arbitrage,” imposing stricter regulations on cross-border swap transactions than on transactions undertaken in a single jurisdiction would seem not to promote a liquid international market.

In the longer run, it seems likely that the swaps regulations of the major jurisdictions will converge. For the foreseeable future, however, both before and after December 21, questions will continue to abound, and the swaps market will continue to be burdened by regulatory uncertainty. As it was the G-20 process that delineated and put in process the swaps market reforms in G-20 member nations, international bodies such as the Basel Committee on Banking Supervision and the Financial Stability Board could likely play a productive role in minimizing confusion and disruption and in bringing much needed clarity to the swaps market.

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52 Id.
53 Id.
54 Id.
55 Id.
56 See Greene & Potiha, supra note 34, at 385–92.
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December 23, 2015

CFTC Adopts Uncleared Swaps Margin Rules

By Julian Hammar

On December 16, 2015, the Commodity Futures Trading Commission (“CFTC” or “Commission”) adopted final rules to impose margin requirements on uncleared swaps entered into by swap dealers and major swap participants subject to CFTC regulation, referred to as “Covered Swap Entities” or “CSEs” in the rules. The CFTC also adopted an interim final rule to exclude from the requirements most uncleared swaps that swap entities enter into with commercial end users, financial institutions with $10 billion or less in total assets, and certain other entities consistent with the requirements of the Business Risk Mitigation and Price Stabilization Act of 2015.

The CFTC’s regulations are largely the same as the rules and interim final rule adopted by the Prudential Regulators (the Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Farm Credit Administration and the Federal Housing Finance Agency) in October 2015 for swap entities subject to their supervision, with a few important differences noted below. The CFTC’s and Prudential Regulators’ rules will significantly impact the economics of the swaps market. Both sets of rules become effective on April 1, 2016, with a compliance schedule discussed below. The CFTC’s final rules are available here, while the Prudential Regulators’ final rules and interim final rule have been published in the Federal Register.¹

BACKGROUND

One of the criticisms of the swaps market in the wake of the 2008 financial crisis was that it did not require swaps counterparties to provide margin (that is, collateral) to secure their obligations to each other. In practice, in many cases before and (even more so) after the crisis, parties have provided collateral (“variation margin”) to cover the current (“mark-to-market”) value of their obligations to each other. Though less common, some parties have also provided upfront collateral (“initial margin”) to cover the potential for further changes in mark-to-market value that could occur over some period (such as 5 business days).

The Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”)² requires the Prudential Regulators, the CFTC and the Securities and Exchange Commission (“SEC”) to draft rules requiring margin for bilateral swaps that will not be cleared at a clearinghouse (cleared swaps, in contrast, are subject to margin requirements imposed by clearinghouses and their members). In fulfillment of the statutory mandate, the CFTC and Prudential Regulators released in the fall of 2014 re-proposed rules for margin requirements for uncleared swap transactions subject to their regulation, which they first proposed in 2011. The re-proposed rules were issued in response to an international framework for uncleared swaps margin stated in a series of papers released by the Basel Committee on Banking Supervision and the Board of the International Organization of


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Securities Commissions, the last of which was issued in September 2013 (the “BCBS/IOSCO Framework”). For more information on the Prudential Regulators’ and CFTC’s proposed rules, please see our alert here.

FINAL RULES EXECUTIVE SUMMARY

Overview of the final rules

Like the Prudential Regulators’ final rules, the CFTC’s final rules in general would:

- Require Covered Swap Entities3 to bilaterally exchange, subject to a $50 million threshold below which it need not be exchanged, “initial margin” with other swap entities and with a broad range of “financial end users,” whose use and affiliates’ use of uncleared swaps meet a notional amount-based exposure (“material swaps exposure”);

- Mandate that all such initial margin, which is intended to secure potential future exposure or adverse changes in value that may arise during the period of time when a swap is being closed out, must be segregated generally with a third-party custodian (not affiliated with either counterparty) and not subject to re-hypothecation or other use by the custodian;4

- Permit the calculation of initial margin by means of either a model-based method, subject to regulatory approval, or a table-based method provided for in the rules;

- Impose a significantly higher initial margin requirement on uncleared swaps as compared to cleared swaps by requiring that initial margin models use a 10 business day closeout horizon for most uncleared swaps as opposed to a 5 business day horizon for most cleared swaps; and

- Require swap entities to exchange “variation margin” with swap entities and with a broad array of financial end users without regard to the existence of material swaps exposure and without any threshold.

Relief provided from the re-proposals in the final rules

Also like the Prudential Regulators’ rules, the CFTC’s rules provide some relief from the re-proposal in certain areas, as well as some harmonization with the BCBS-IOSCO Framework. Specifically, the Prudential Regulators’ and CFTC’s rules, as discussed in more detail below, would:

- Increase the material swaps exposure amount for financial end users from $3 billion to $8 billion of average daily aggregate notional amount of swaps activity over a three-month period, thereby decreasing the number of entities from and to which Covered Swap Entities must post and collect initial margin and aligning the amount with the BCBS/IOSCO Framework;

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3 Under the CFTC’s rules, Covered Swap Entities are swap dealers and major swap participants for which there is no Prudential Regulator, while under the Prudential Regulators’ rules, Covered Swap Entities include swap dealers, major swap participants, security-based swap dealers and major security-based swap participants that are regulated by a Prudential Regulator.

4 However, the Prudential Regulators and the CFTC clarify that cash collateral may be held in a general deposit account with the custodian if the funds in the account are used to purchase other forms of eligible collateral, such eligible non-cash collateral is segregated, and the purchase of which takes place within a time period reasonably necessary to consummate such purchase after the cash collateral is posted as initial margin. See 17 C.F.R. 23.157(c) and Prudential Regulators Rule __.7(c).
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- Harmonize dollar amounts for the initial margin threshold and minimum transfer amount with the BCBS-IOSCO Framework in light of changed exchange rates;

- Revise the definition of affiliate to eliminate a test of affiliation based on “control” in favor of consolidation under accounting rules, which should make certain calculations easier, such as for material swaps exposure, required by the rules;

- Expand the eligible collateral for initial and variation margin by permitting redeemable securities in certain money market mutual funds for initial margin and providing that variation margin collateral, which under the re-proposals could only be in cash, may be in any form that is eligible for initial margin for swaps between CSEs and financial end users;

- Modify treatment of pre- and post-compliance date swaps under “eligible master netting agreements” (agreements meeting certain requirements under which variation margin can be calculated on a net basis and risk offsets recognized for calculating initial margin); and

- Amend the phased-in compliance schedule for the rules in accordance with delay of the schedule announced by BCBS and IOSCO earlier this year by 9 months.

**Notable differences between the CFTC’s and Prudential Regulators’ rules**

The CFTC’s final rules have a few notable differences from the Prudential Regulators’ rules, including:

- Providing for a broader exemption from swaps between Covered Swap Entities and their affiliates than the more limited exemption provided by the Prudential Regulators, but with an anti-evasion provision;

- Delegating authority to the National Futures Association (“NFA”), the self-regulatory organization in the futures and swaps industry, to approve initial margin models, which could also be approved by the CFTC (the Prudential Regulators would undertake their own approvals);

- Excluding from the financial end user definition treasury affiliates that qualify for an exemption from mandatory clearing that the CFTC has exempted by rule (the Prudential Regulators have stated that they will include this provision if the CFTC acts to exempt such entities, which currently qualify for an exemption under CFTC staff no-action letters, by rule);

- Requiring that the variation margin calculation use methods, procedures, rules, and inputs that, to the maximum extent practicable rely on recently executed transactions, valuations provided by independent third parties, and other objective criteria (the Prudential Regulators’ rules do not contain this provision); and

- Not addressing cross-border application of the rules, which are being considered by the CFTC in a separate proposal.

Even with the relief provided for in the CFTC’s and the Prudential Regulators’ rules, however, the obligations of the rules represent a significant regulatory burden and cost on the OTC swaps market that did not exist before. It remains to be seen how the swaps market will respond to these requirements.
SCOPE OF THE FINAL RULES

Financial end users

Under both the CFTC’s and Prudential Regulators’ rules, a Covered Swap Entity will not be required to collect or post specified amounts of initial or variation margin on swaps with counterparties that are not swap entities or “financial end users.” Such counterparties are described in the final rules as “other counterparties” by the Prudential Regulators and “non-financial end users” by the CFTC. The final rules retain the “financial end user” definition used in the re-proposal (a list of enumerated financial market status types under various U.S. statutes and regulations including banks, broker-dealers, investment companies, insurance companies, commodity pools and ERISA plans), which was intended to provide greater clarity than the “financial entity” definition used in the statutory exemption from mandatory clearing in the Commodity Exchange Act (“CEA”). Expressly excluded from the financial end user definition are sovereign entities (central governments or an agency or department thereof), the Bank for International Settlements, multilateral development banks, entities exempt from the definition of financial entity under section 2(h)(7)(C)(iii) or (D) of the CEA or section 3C(g)(4) of the Securities Exchange Act of 1934 (“Exchange Act”), and, as noted above, the CFTC’s rules include an exclusion for treasury affiliates that qualify for an exemption from mandatory clearing that the CFTC has exempted by rule (currently exempted by staff no-action letters). The Prudential Regulators and the CFTC declined to exclude structured finance vehicles or covered bond issuers that had been requested by commenters.

Requirements for swaps with non-financial end users

Swaps with entities that are not financial end users are exempt from the margin requirements under both the CFTC’s and the Prudential Regulators’ rules, except under the Prudential Regulators’ rules, a Covered Swap Entity must collect margin (if any) from such non-financial end users as the CSE determines is appropriate in its overall credit risk management of its exposure to the customer. CSEs must make this determination for entities that do not qualify for the separate interim final rule (e.g., a commercial end user that is not hedging or mitigating commercial risk), as well as with respect to initial margin for financial end users without material swaps exposure (who are not subject to the rule’s initial margin requirements). The CFTC’s release does not require this determination, and also removes the requirement contained in the CFTC’s re-proposal that CSEs calculate margin requirements for these entities.

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5 See 17 C.F.R. 23.151 and Prudential Regulators Rule __.2 (definition of financial end user). The Prudential Regulators and the CFTC added to the financial end user definition a U.S. intermediate holding company established or designated for purposes of compliance with the Federal Reserve Board’s Regulation YY (12 C.F.R. 252.153), and three CFTC-registered entities to the enumerated list: floor brokers, floor traders, and introducing brokers. The CFTC also added business development companies to align its financial end user definition with that of the Prudential Regulators. Both sets of rules include a provision that would cover an entity, person, or arrangement that is, or holds itself out as, as 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. See (xi) of the financial end user definition. The final rules also remove the provision contained in the re-proposals that would have included any other entity that the relevant agency determined should be treated as a financial end user.

6 Multilateral development banks are separately defined in the rule to include certain specified entities.

hypothetical margin requirements for swaps with non-financial end users, citing the administrative burden and that other CFTC rules should address monitoring of risk exposures for these entities.\(^8\)

**Interim final rule exemption**

The CFTC, like the Prudential Regulators, also adopted an interim final rule in accordance with the Business Risk Mitigation and Price Stabilization Act of 2015, which provides that the requirements of the uncleared swaps margin rules do not apply where the counterparty would be eligible for:

- An exemption from mandatory clearing under Section 2(h)(7)(A) of the CEA or Section 3C(g)(1) of the Exchange Act (i.e., a non-financial entity using the swap to hedge or mitigate commercial risk, certain small financial institutions and captive finance companies);

- An exemption under CEA Section 4(c)(1) for cooperative entities that would otherwise be subject to the requirement to clear; or

- The exemption for affiliates under CEA Section 2(h)(7)(D) or Exchange Act Section 3C(g)(4) (i.e., affiliates that act as an agent).\(^9\)

**KEY MODIFICATIONS TO THE RE-PROPOSALS IN THE FINAL RULES**

The CFTC’s and the Prudential Regulators’ final rules make a number of modifications to the re-proposals, as noted above, which provide relief in some cases as well as some harmonization with the BCBS/IOSCO Framework. The discussion of these modifications below also highlights differences between the CFTC’s and Prudential Regulators’ rules.

**Material swaps exposure**

Under both the CFTC’s and the Prudential Regulators’ final rules, the threshold for determining whether a financial end user has “material swaps exposure” has been increased from $3 billion to $8 billion of average daily aggregate notional amount of swaps activity for June, July, and August of the previous calendar year (determined by reference to the swaps activity of the financial end user and its affiliate(s) on business days), which is more closely aligned with the BCBS-IOSCO Framework. This change will reduce the number of entities from which swap entities must post and collect initial margin, which is required under the rules for swaps between swap entities and financial end users with material swaps exposure, and level the playing field between swap entities subject to U.S. rules and those subject to rules of foreign jurisdictions, such as the European Union and Japan, which have more closely followed the BCBS-IOSCO Framework. Both sets of rules also clarify that swaps eligible for an exemption under the interim final rule do not count toward this threshold and that swaps entered into between an entity and its affiliate are counted only once to prevent double counting.

A new provision common to both the CFTC’s and Prudential Regulators’ rules not contained in the re-proposals clarifies the consequences of a change in a counterparty’s status. Under the new provision, if a change would

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\(^8\) See CFTC Final Rule Release at 48.

\(^9\) 17 C.F.R. 23.150; Prudential Regulators Interim Final Rule.
make the rules stricter, such as when a financial end user becomes a financial end user with material swaps exposure, the stricter rules would apply for new swaps entered into after the change. Where a change would make the rules less strict (such as when the exposure of a financial end user with material swaps exposure falls below the $8 billion threshold), the swap entity may comply with less strict requirements for all outstanding swaps. Accordingly, initial margin, which is not required for swaps with financial end users that do not have material swaps exposure, would no longer be required with respect to all swaps under this provision if a financial end user drops below the $8 billion threshold.10

Changes to other numerical amounts

In addition to the modification to the material swaps exposure amount, both the CFTC’s and the Prudential Regulators’ rules modify other numerical amounts contained in the re-proposals to take into account changed exchange rates that have occurred since the re-proposals were issued. Specifically, the initial margin threshold amount—i.e., the amount under which initial margin need not be collected—has been reduced from $65 million in the re-proposals to $50 million in the final rules due to changed exchange rates.11 Similarly, the minimum transfer amount across initial and variation margin—or the amount below which initial and variation margin need not be exchanged until it is exceeded—has been reduced from $650,000 to $500,000 in the final rules.12

Definition of affiliate

Under both the CFTC’s and the Prudential Regulators’ final rules, the definition of “affiliate” (“margin affiliate” in the CFTC’s rules) has been aligned with established accounting standards rather than relying on the “control” test contained in their re-proposals. The re-proposals contained a low level of control for affiliation to exist—only 25 percent (not 50 percent or more) of the ownership or control, directly or indirectly, of a class of voting securities or total equity. The final rules provide that affiliation exists if a company consolidates the other (or both companies are consolidated with a third company) on financial statements prepared in accordance with U.S. Generally Accepted Accounting Principles, the International Financial Reporting Standards, or other similar standards.13 The change may make it easier for companies to determine whether, for example, a financial end user has “material swaps exposure” (which must be calculated to include the exposures of its affiliates), as well as determine compliance deadlines under the phased-in compliance schedule discussed below. The CFTC did not include in its affiliate definition a provision included in the Prudential Regulators’ definition of the term “affiliate” pursuant to which the relevant Prudential Regulator may determine that a company is an affiliate of another company based on the regulator’s conclusion that either company provides significant support to, or is materially subject to the risk of losses of, the other company.

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10 See 17 C.F.R. 23.161(c) and Prudential Regulators Rule __.1(g).
11 See 17 C.F.R. 23.151 and Prudential Regulators Rule __.2 (definition of initial margin threshold amount).
12 See 17 C.F.R. 23.151 and Prudential Regulators Rule __.2 (definition of minimum transfer amount). In addition to these modifications, the CFTC’s and Prudential Regulators’ rules provide clarification about when margin must be collected, when counterparties are in different time zones or observe different legal holidays. See CFTC Final Rule Release at 54-57 and 80 Fed. Reg. at 74864-65.
13 See 17 C.F.R. 23.151 (definition of “margin affiliate”) and Prudential Regulators Rule __.2 (definition of affiliate).
Expansion of eligible collateral for initial and variation margin

The CFTC’s and Prudential Regulators’ rules also expand the types of eligible collateral for initial and variation margin. Eligible collateral types for initial margin include U.S. Treasury securities, government sponsored enterprise securities, securities issued or guaranteed by the Bank for International Settlements, the European Central Bank, the International Monetary Fund and multilateral development banks, publicly traded debt (other than asset-backed securities), publicly traded equities in certain indices and gold, but not securities issued by the pledgor or its affiliate or banks and similar entities. The final rules also permit collateral (not permitted in the re-proposals) of redeemable securities in certain money market mutual funds that meet specific requirements.14

The CFTC’s and Prudential Regulators’ final rules also provide that variation margin may include major currencies (defined in the final rules)15 in addition to U.S. dollars and the currency of settlement, while the re-proposals would not have permitted major currencies. An 8 percent cross-currency haircut applies if margin is denominated in a currency different from settlement currency, except that variation margin in immediately available cash funds in the major currencies is not subject to the haircut.

Both sets of final rules also permit non-cash collateral eligible to be used for initial margin to serve as variation margin for swaps between a Covered Swap Entity and a financial end user (but not for swaps with other swap entities), while the re-proposals only permitted cash collateral for variation margin for all counterparties.16 This change may be welcomed by certain financial entities, such as insurance companies, that hold significant reserves of bonds and other securities and commented that the restriction to cash-only variation margin would reduce their investment returns.

The CFTC’s rules include a provision, not included in the Prudential Regulators’ rules, that requires that variation margin calculations use methods, procedures, rules, and inputs that, to the maximum extent practicable rely on recently executed transactions, valuations provided by independent third parties, or other objective criteria.17

Approval of initial margin models

The CFTC’s and the Prudential Regulators’ final rules differ in terms of the approval of initial margin models. Both sets of final rules, like the re-proposals, impose stringent regulatory requirements on initial margin models, including written approval of the relevant regulator for use of initial margin models, demonstration on an ongoing basis that the model satisfies all of the requirements under the rules, and prior notice to the relevant regulator before making changes to the model or its assumptions. However, the CFTC’s final rules would provide a


15 The major currencies are United States Dollar (USD); Canadian Dollar (CAD); Euro (EUR); United Kingdom Pound (GBP); Japanese Yen (JPY); Swiss Franc (CHF); New Zealand Dollar (NZD); Australian Dollar (AUD); Swedish Kronor (SEK); Danish Kroner (DKK); Norwegian Krone (NOK); and any other currency designated by the CFTC or relevant Prudential Regulator. See 17 C.F.R. 23.151 and Prudential Regulators Rule __.2 (definition of major currency).

16 See 17 C.F.R. 23.156(b)(1)(ii) and Prudential Regulators Rule __.6(b).

17 Both releases clarify, in response to comments that the re-proposals appeared to require calculation of variation margin based on the market value of the swap calculated from the Covered Swap Entity’s perspective, that the market value used to determine the cumulative mark-to-market change will be mid-market prices, if that is consistent with the agreement of the parties. CFTC Final Rule Release at 114-15, 80 Fed. Reg. at 74,867.
registered futures association (the NFA is the only registered futures association) with authority to approve initial margin models in addition to the CFTC. The Prudential Regulators’ final rules do not contain a similar provision; all approvals of initial margin models for Covered Swap Entities subject to their supervision will have to be approved by the relevant Prudential Regulator. The CFTC notes that it or the NFA will coordinate with the Prudential Regulators in order to avoid duplicative efforts and to provide expedited approval of Prudential Regulator-approved models.

Eligible master netting agreements

Relief was also provided by the CFTC and the Prudential Regulators from their re-proposals with respect to pre-compliance date and post-compliance date swaps subject to a single eligible master netting agreement (“EMNA”). For swaps subject to an EMNA, variation margin can be calculated on a net basis and risk offsets can be recognized within asset classes for calculating initial margin. Under the re-proposals, although the rules applied only to swaps entered into after the relevant compliance date, transactions subject to an EMNA applicable to pre-compliance date transactions would be subject to margin requirements for all swaps under the EMNA. Accordingly, without the relief provided for in the final rules, counterparties would have had to enter into a separate EMNA for new swaps, which received criticism from commenters who argued that this would reduce netting sets and thus increase systemic risk.

Both sets of final rules permit counterparties to document pre- and post-compliance date swaps as separate portfolios for netting purposes under the same EMNA covered by separate credit support annexes. Accordingly, netting portfolios that contain only uncleared swaps entered into before the applicable compliance date are not subject to the final rules. EMNAs, as provided under the re-proposals, are subject to a requirement that a swap entity conduct sufficient legal review to 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. Although unqualified legal opinions are not required, the legal review must be in writing. Also with regard to EMNAs, the definition of EMNA is amended in the final rules to provide that impermissible “walk away” clauses do not include clauses that only suspend payment obligations when a counterparty defaults. A provision included in the Prudential Regulators’ final rules that, if a netting agreement does not qualify as an EMNA, the Covered Swap Entity must collect variation margin on a gross basis but may post on a net basis, is not contained in the CFTC’s final rules.

18 See 17 C.F.R. 23.154(b).
19 See Prudential Regulators Rule __.8(c).
20 See CFTC Final Rule Release at 74.
22 See generally CFTC Final Rule Release at 79-80 and 80 Fed. Reg. at 74,862. A similar legal review requirement applies to custodial agreements with third party custodians for initial margin. The CFTC and Prudential Regulators provide guidance that, for that purpose, the relevant jurisdictions include that of the custodian as well as that of the Covered Swap Entity’s counterparty. See CFTC Final Rule Release at 139 and 80 Fed. Reg. at 74,875.
23 In this regard, the definition of EMNA has been modified to align it with the definition of qualifying master netting agreement in the risk-based capital rules that was modified earlier this year. See 80 Fed. Reg. at 74861-62.
Inter-affiliate swaps

Neither the CFTC’s nor the Prudential Regulators’ re-proposals contained an exemption from the margin requirements for swaps between a Covered Swap Entity and its affiliates. As mentioned above, the Prudential Regulators’ and the CFTC’s final rules differ on the treatment of such inter-affiliate swaps.

Under the Prudential Regulators’ final rules, the margin requirements generally apply to swaps between a Covered Swap Entity and its affiliates (unless otherwise exempt), except that a Covered Swap Entity is not required to post initial margin to an affiliated counterparty. The Covered Swap Entity is required to calculate the amount of initial margin that would be required to be posted under the rules to an affiliate (that is a financial end user with material swaps exposure) and provide documentation of such amount on a daily basis. The threshold for collecting initial margin from an affiliate that is a financial entity with material swaps exposure is $20 million (rather than the generally applicable $50 million threshold). The Prudential Regulators’ rules do not provide relief from variation margin, which must be posted to and collected from financial end user affiliates by swap entities. Initial margin in the form of non-cash collateral for swaps between a swap entity and its affiliates may be held by a custodian that is an affiliate of the Covered Swap Entity or by the Covered Swap Entity itself (rather than an unaffiliated third party as required for uncleared swaps with non-affiliates). The Prudential Regulators’ final rule allows a Covered Swap Entity to use a 5 business day close-out time horizon for modelling the initial margin requirement, rather than the generally applicable 10 business day horizon, for swaps that are required to be cleared but which are exempt because of a clearing exemption for inter-affiliate swaps. It should be noted that, if an affiliate of a swap entity is itself a swap entity, then the Prudential Regulators’ rules require that both swap entities must collect margin, and thus there is no relief from the posting requirement.

Under the CFTC’s final rules, a Covered Swap Entity is generally not required to collect initial margin from a margin affiliate (including another swap entity), provided that the CSE meets the following conditions:

- The swaps are subject to a centralized risk management program that is reasonably designed to monitor and manage the risks associated with inter-affiliate swaps; and
- The CSE exchanges variation margin with the margin affiliate.

The CFTC’s final rules provide, however, that a Covered Swap Entity must collect initial margin from non-U.S. affiliates that are financial end users that are not subject to comparable initial margin collection requirements on their own outward-facing swaps with financial end users. In addition, in order to facilitate compliance with the Prudential Regulators’ rules, the CFTC’s rules would require a Covered Swap Entity to post initial margin with a swap entity that is subject to the Prudential Regulators’ rules (and required to collect initial margin from its affiliates). As is the case under the Prudential Regulators’ rules, the CFTC’s rules would require that variation margin be exchanged with respect to swaps between a Covered Swap Entity and its affiliates.

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24 See Prudential Regulators Rule __.11.
25 See 17 C.F.R. 23.159.
Phased-in compliance schedule

Both the CFTC’s and the Prudential Regulators’ final rules adopt the phase-in schedule announced by BCBS/IOSCO in March 2015, which delays implementation of initial margin and variation margin requirements by nine months compared with the re-proposals, starting in September 1, 2016. The compliance schedule is nonetheless aggressive in light of the legal, operational, and regulatory approval requirements imposed by the rules. The final rules provide for phased-in implementation for initial margin depending upon swaps exposure of the Covered Swap Entity and its affiliates and its counterparties and their affiliates starting from September 1, 2016 (for entities with the largest exposure) through September 1, 2020, after which swaps with all financial end users with material swaps exposure will be subject to the initial margin requirements.

The CFTC’s and Prudential Regulators’ final rules also provide for a delayed-implementation schedule with regard to variation margin for Covered Swap Entities belonging to a group whose aggregate month-end average notional amount of non-centrally cleared derivatives is less than $3 trillion for March, April and May 2016, until March 1, 2017. For all other Covered Swap Entities, the compliance date for variation margin is September 1, 2016.

The final rules clarify that, once a CSE and its counterparty (and their affiliates) become subject to the margin requirements under the schedule, they remain subject to the requirements even if they have a change in status due to a reduction in notional exposure (this differs from the rule explained earlier when a financial end user with material swaps exposure changes status and the less strict margin requirements apply). The Prudential Regulators and the CFTC declined to provide guidance in response to commenters’ requests that certain swaps be considered to be entered into before the applicable compliance date.

Cross-border application

The Prudential Regulators’ final rules contain provisions governing the cross-border application of the margin rules, while the CFTC has proposed a separate rulemaking to address cross-border application, which has not yet been finalized. The Prudential Regulators’ final rules, as under the re-proposal, exempt foreign swap entities (but not their U.S. branches or agencies) with respect to the foreign non-cleared swaps from the margin requirements. The exemption is not available where the foreign counterparty is, or is guaranteed by, a U.S. entity, a U.S. branch or subsidiary of a foreign bank, or a foreign swap entity that is a subsidiary of a U.S. entity. Substituted compliance (i.e., compliance with non-U.S. rules rather than U.S. rules) may be available for a foreign bank, U.S. branch or agency of a foreign bank, or an entity that is a foreign subsidiary of a depository institution, Edge corporation or agreement corporation. However, substituted compliance would be available only if the Prudential Regulators have made a comparability determination for the jurisdiction the rules of which would apply to the uncleared swap. Moreover, substituted compliance would not be available if the swap is guaranteed by a U.S. entity.

26 See 17 C.F.R. 23.161 and Prudential Regulators Rule ___ .1(e).
27 See Prudential Regulators Rule ___ .9. For more information on the CFTC’s proposed rules regarding cross-border application of the uncleared swaps margin requirements, please see our client alert here.
Client Alert

All swap entities (including U.S. entities) under the Prudential Regulators’ rules will be deemed to satisfy the initial margin posting requirement under the final rules if they post the amount of initial margin that each of their counterparties is required to collect under non-U.S. rules, provided that the Prudential Regulators have made a substituted compliance determination with respect to those rules and the swap is not subject to a guarantee from a U.S. entity. The Prudential Regulators’ final rules also provide relief in certain circumstances from the segregation requirements to foreign branches and subsidiaries of U.S. banks and Edge corporations where inherent limitations in the legal or operational infrastructure in a foreign jurisdiction make it impracticable to segregate collateral.28

CONCLUSION

The CFTC’s and Prudential Regulators’ final rules provide some welcome relief to market participants when compared with the re-proPOSALS, and the harmonization efforts with non-U.S. regulators should help to create a more level playing field. Nonetheless, the margining requirements imposed by the rules represent a significant regulatory burden and cost on the OTC swaps market that did not exist before, in particular as it pertains to initial margin, which, due to the segregation and re-hypothecation restrictions, will impose a significant new cost for swap dealers and financial end users with material swaps exposure. Because of the 10 business day close-out requirement for calculating initial margin, this cost will be substantially higher than other derivative products, such as cleared swaps or futures. It remains to be seen how the swaps market will respond to these requirements and whether, as a result of their cost, the use of other derivative products, such as cleared swaps and futures, may be used in place of OTC swaps.

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28 See Prudential Regulators Rule __.9(f).
Valuing Derivatives in a Bank Bail-In

Under the EU’s Bank Recovery and Resolution Directive (“BRRD”)¹, one of the key powers given to national resolution authorities is the ability to impose losses on, or “bail-in”, certain financial liabilities of the failing bank in a resolution action, either by writing down the principal amount of the liability or converting it into equity. One of the main aims of a bail-in is to ensure that creditors and/or shareholders can be made to bear an appropriate proportion of the failing institution’s losses, in order to minimise the need for the application of public funds (a “bail-out”).

The BRRD provides that all liabilities of the bank in resolution can be bailed-in, unless they are contained on an express list of excluded liabilities, or are excluded from bail-in pursuant to the discretion of the relevant resolution authority, which can be exercised in exceptional circumstances. As a result, derivatives liabilities are eligible for bail-in, except to the extent that they meet the criteria for one of the express exclusions. In order to facilitate such a bail-in of a derivative liability, however, such transactions firstly need to be terminated and closed-out and valued for the purpose of Article 36 of the BRRD. This process raises significant issues for market participants, who will no doubt be keen to ensure that, in the event that their derivatives transactions are mandatorily terminated earlier than intended, their net exposure is valued in a way that is consistent with expectations resulting from their contractually negotiated trading documentation.

The European Banking Authority (“EBA”) recently published draft regulatory technical standards (the “RTS”)² applicable to the valuation of derivatives following the application of the bail-in power to such contracts. The EBA’s authority to release the publication stems from Article 49(5) of the BRRD, which requires it to set out (i) appropriate methodologies for valuing derivative transactions, (ii) principles for establishing the relevant point in time at which valuations should be established, and (iii) methodologies for comparing the destruction in value that might arise from close-out and bail-in, with the amount of losses that would be borne by derivatives in a bail-in. We consider the EBA’s approach to each of these issues below.

Scope

There are general exclusions from the scope of bail-in under Article 44(2) of the BRRD, including (but not limited to) covered deposits, certain liabilities with a maturity of less than seven days and liabilities to employees, trade creditors or taxing authorities. Some of these exclusions will be relevant to derivatives as well as other financial instruments. In particular, it should be noted that secured liabilities are excluded to the extent that the value of the liability does not exceed the value of the collateral, as are liabilities of less than seven days’ remaining maturity to payment and settlement systems. Accordingly, since over-the-counter derivatives of EU banks are increasingly

likely to be subject to either (a) mandatory clearing (resulting in the mandatory application of stringent margin requirements) or (b) collateralisation requirements in respect of uncleared trades (in each case, under the European Market Infrastructure Regulation ("EMIR")), the universe of derivatives that are likely to be subject to bail-in is likely to become increasingly limited in the future.

**Close-Out and Netting**

As a first step in the bail-in process, the BRRD itself lays down the parameters for valuing derivatives liabilities. In particular, Article 49(2) of the BRRD provides that write-down and conversion powers apply only upon or after relevant derivatives have been closed-out. Accordingly, resolution authorities have the power to terminate and close-out any derivative contract (that is not excluded from application of the bail-in tool) for that purpose. In addition, Article 49(3) requires that, where derivative transactions are subject to a netting agreement, the liability arising from such transactions must be determined on a net basis, in accordance with the terms of the underlying netting agreement.

**Valuation Methodology**

*Uncleared Transactions*

Once the derivative liabilities in the relevant “netting set” have been closed-out, the principal guiding methodology of the RTS, in valuing the closed-out liability, is that of the “replacement cost” of the relevant derivatives. A derivative’s value is intended to be determined by reference to the costs incurred by a non-defaulting party in replacing the terminated contract (having taken any posted or received collateral into account).

This methodology may therefore result in a different valuation from one derived from the methodology elected by the two counterparties in their contractual agreement, the latter being disregarded for the purpose of the Article 36 valuation.

Article 2 of the draft RTS sets out the following steps for closing-out and valuing trades that are not centrally cleared:

1. The resolution authority must notify the relevant counterparty that its derivative contract(s) is/are to be terminated, specifying the proposed date for close-out.

2. The resolution authority will also notify the relevant counterparty of a date by which the counterparty must provide (a) evidence of commercially reasonable replacement trades and (b) a summary of any replacement trades. For more illiquid trades where replacement quotes might be less forthcoming, a counterparty may find it difficult to present the required valuation evidence. There is also no guidance with respect to precisely what constitutes appropriate evidence in this regard.

So long as evidence of actual commercially reasonable replacement trades is provided within the requisite time period, the applicable valuer (an independent valuation agent appointed in accordance with Article 36 of the BRRD or, where this is not possible, the resolution authority) will determine the early termination amount at the prices of those replacement trades.

However, in circumstances where the valuer concludes that the replacement trades were not concluded on commercially reasonable terms, or where the counterparty fails to provide sufficient or acceptable evidence by the deadline provided, the valuer will determine the close-out amount based on (1) mid-market end-of-day prices on the specified close-out date or (if that is not commercially reasonable) the time at which a price is available in the

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market for the underlying asset, (2) the mid-to-bid or mid-to-offer spread (depending on the direction of the netted risk position) in order to estimate loss or cost incurred as a result of close-out in liquidating, obtaining or re-establishing a hedge or related trading position, and (3) adjustments to (2) above in order to reflect the size of the exposure and credit-worthiness of the counterparty.

For this purpose, the valuer may take into account valuations generated on its own systems, data extracted from the institution under resolution (such as internal models and valuations) and third-party market and price information, as well as any other relevant data.

In order to provide certainty for the resolution authority in relation to the valuation, the BRRD provides for no automatic right of challenge or appeal for a creditor. However, it is a fundamental principle of the BRRD, contained in Article 73, that no creditor should be worse off in the bail-in action than it would have been in a conventional insolvency action. In order to give effect to that principle, Article 74 provides for a second independent valuation to be performed as soon as possible after the bail-in action has been effected. The purpose of this valuation is to assess whether shareholders or creditors would have fared better in an insolvency proceeding and, if so, by how much, so that the resolution authority can assess how much compensation would be payable to the relevant shareholder or creditor in order to reflect the “no creditor worse off” principle.

Cleared Transactions

For derivatives trades that are centrally cleared, the resolution authority will notify the central clearing counterparty (“CCP”) that it wishes to terminate the applicable transactions, and close-out shall take place either immediately or at a later close-out date specified in the notification. In these circumstances, the valuer must establish the value of liabilities which arise from derivatives contained in groups of transactions covered by the same netting agreement (“netting sets”) entered into between the institution under resolution (in its capacity as a clearing member) and the CCP. The RTS suggest that, in this case, the CCP will assume responsibility for determining the early termination amount in accordance with its standard default procedures. CCPs are required (under EMIR) to have default procedures in place which will typically include, as a first step, compulsory efforts to transfer or “port” the cleared trades to another clearing member and, failing that, an attempt by the CCP to auction off the defaulted trades to non-defaulting clearing members. The auction price will represent a cost or gain for the CCP and should therefore adequately reflect such transaction’s replacement cost. Following this procedure, the CCP will then have to report the early termination amount applicable to each affected netting set and provide the resolution authority with the default management steps undertaken to liquidate or re-hedge the positions of the defaulted clearing member.

In most cases, the defaulting clearing member is highly unlikely to generate losses in excess of posted collateral. As such, the bailing-in of cleared derivatives is itself generally unlikely to occur in normal market conditions because of the express bail-in exclusion for secured liabilities.

Point in Time for Establishing Derivatives Liabilities

The value of derivative liabilities shall be determined by the applicable valuer at the following points in time:

1. where the valuer determines an early termination amount at the prices of replacement trades provided by the counterparty, the day and time of the replacement trades;
2. where the valuer determines an early termination amount in accordance with CCP default procedures, the day and time when the early termination amount is determined by the CCP; or
3. in all other cases, the close-out date or, if that is not commercially reasonable, the date and time when a price for the underlying asset is available in the market.
Destruction in Value

As an additional step in the valuation process, the BRRD requires that resolution authorities should also make efforts to avoid any unnecessary destruction in value in relation to the relevant derivatives transaction.

Therefore, Article 44(3)(d) of BRRD provides that one ground on which a resolution authority is permitted to exclude a liability from bail-in is where the bail-in of that liability would cause a destruction in value resulting in the losses borne by other creditors being higher than if that liability were not bailed-in. For this purpose, Article 49(5) of BRRD directs the EBA to develop RTS, specifying appropriate methodologies for comparing the destruction in value that would arise from the close-out and bail-in of derivatives liabilities with the amount of losses that would be borne by the bailed-in derivatives liabilities. Article 8 of the RTS therefore provides an additional safeguard, by requiring that resolution authorities must (prior to making a decision that results in close-out of the applicable transaction(s)) make a comparison between (a) the amount of losses that would be borne by derivatives contracts in a bail-in scenario and (b) the destruction in value based on an assessment of the costs, expenses or other impairment of value that is expected to be incurred as a result of the close-out of the derivatives contracts. Elements to be considered as part of the possible destruction in value include (i) the risk of an increased counterparty close-out claim arising from re-hedging costs, (ii) the cost expected to be incurred by the bank in resolution in re-establishing hedges or maintaining an acceptable risk profile, (iii) any reduction to franchise value arising from close-out and any impact to funding costs or income levels, and (iv) any precautionary buffer against possible adverse implications from close-out, such as errors and disputes in respect of transactions or collateral exchange.

Implementation

ESMA has invited market participants to provide comments on the draft RTS by 13 August 2015. The draft RTS are required to be submitted to the European Commission by 3 January 2016.

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Collateralising Uncleared Derivatives Trades under EMIR – Draft Regulatory Technical Standards

On April 14, 2014, the European Supervisory Authorities (“ESAs”)¹ published the anticipated first draft regulatory technical standards (“RTS”) on risk-mitigation techniques for over the counter (“OTC”) derivatives contracts that are not cleared by a central clearing counterparty (“CCP”) under Article 11(15) of the European Market Infrastructure Regulation (“EMIR”)². Article 11(15) requires that technical standards be developed by the ESAs in respect of risk management procedures that will ensure timely, accurate and appropriately segregated exchange of collateral. This requirement is a component of EMIR’s broader aim of improving the safety and transparency of OTC derivatives markets as a whole. However, given the recent results of the International Swaps and Derivatives Association 2014 Margin Survey³, which stated that “90% of non-cleared OTC derivatives trades were subject to collateral agreements at the end of 2013”, it remains to be seen how much of an impact the new rules will actually have on the OTC derivatives market.

In order to restrict possibilities for international arbitrage and to ensure that there is consistency at an international level, the ESAs have made efforts to try and ensure, where possible, that the RTS are consistent with international standards on margin requirements for non-centrally cleared trades, as represented by the September 2013 paper from the Basel Committee for Banking Supervision (“BSCS”) and the International Organisation of Securities Commissions (“IOSCO”) (the “BSCS/IOSCO Standards”).

Who is affected by the RTS?

The collateralisation requirements of the RTS are a risk-mitigation requirement under Article 11 of EMIR. As such, they primarily (although not exclusively) impact entities that are established in the EU. In particular, EMIR requires that such collateralisation requirements apply to EU financial counterparties and non-financial counterparties that are trading OTC derivatives in excess of the clearing threshold (so called “NFC+” entities and referred to in the RTS collectively, with financial counterparties, as “Counterparties”). As with other risk-mitigation requirements, non-EU entities will only be directly obligated by the requirements of the RTS, to the extent that they trade non-cleared OTC derivatives with certain other non-EU entities and such transactions have a “direct, substantial and foreseeable” effect within the EU⁴. However, non-EU entities that trade with EU-established entities (who are subject to the margin requirements) are likely to find that they will still need to put collateralisation procedures in place, in order to allow their EU-established counterparties to comply with the RTS.

¹ Comprised of the European Securities and Markets Authority (“ESMA”), the European Banking Authority (“EBA”) and the European Insurance and Occupational Pensions Authority (“EIOPA”).
³ http://www2.isda.org/functional-areas/research/surveys/margin-surveys/
Exemptions

It is proposed that certain Counterparties will not have to comply with all of the margin requirements set out in the RTS. These include Financial Counterparties and NFC+ entities, in respect of any transactions entered into with Non-Financial Counterparties that trade below the clearing threshold (“NFC-” entities). In such case, neither initial nor variation margin needs to be exchanged. It is interesting to note, however, that third-country entities who are “equivalent” to NFC- entities in the EU, are not proposed to be covered by this exemption. Financial counterparties trading with other financial counterparties or non-financial counterparties\(^5\), where the total amount of margin to be exchanged between them at a group level, would be equal to or less than €50 million, will also benefit from this exemption. In this case, however, such Counterparties can only agree that initial margin does not need to be posted, and instead they will hold capital against their exposure to their counterparties. Variation margin must still be posted and collected (see below for discussion on initial and variation margin). Again, third-country NFC + or – entities cannot presently avail themselves of this exemption.

Financial counterparties and NFC+s may also agree that where the total collateral exchanged between two counterparties would be equal to or lower than €500,000 (the minimum transfer amount), they will not exchange collateral (initial or variation).

Collateral need not be exchanged in respect of any transactions entered into by Counterparties trading with entities that are exempt from EMIR. This means that non-cleared OTC trades entered into with exempt entities such as EU-based central banks and certain listed multilateral development banks will not be subject to margin requirements (initial or variation). However, the same trades entered into with third-country central banks (not including those exempted by the EU Commission under Article 1(6) of EMIR) and non-listed multilateral banks will be subject to margin requirements.

It is also possible for Counterparties to agree that they do not have to post initial margin on physically settled foreign exchange swaps or forwards, or on the exchange of principal with respect to a currency swap. Variation margin, however, must still be posted and collected. This approach is in line with the BCBS/IOSCO Standards and as a consequence, the ESAs’ view is that requiring initial margin to be posted for these types of transactions would place the EU at a competitive disadvantage vis-à-vis these markets.

Finally, it should also be noted that neither initial nor variation margin need be posted by covered bond issuers or cover pools, provided that certain conditions are met. These include (amongst others) a requirement that the relevant derivative is not terminated if the covered bond issuer defaults, that the derivative counterparty ranks at least equally with covered bond holders and that the covered bond programme must be subject to a legal collateralisation requirement of at least 102%. These conditions are proposed in order to provide the derivative counterparty with an element of protection, while accepting that covered bond issuers and cover pools will find it difficult to post collateral if it is required\(^6\).

It is noticeable, however, that the RTS are silent as regards any possible exemptions for securitisation vehicles. In many cases, this will not be a concern, since such vehicles will most often not qualify as financial counterparties or NFC+s\(^7\). However, for larger, multi-issuance, EU-established vehicles that may trip the clearing threshold tests, this suggests that they will be required by their swap counterparties to post collateral. This would make no economic sense in a case where the swap counterparty already benefits from a shared interest in other security provided by the vehicle over its assets, and is one area in which clarification of the RTS may be needed.

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\(^5\) This includes NFC+’s.
\(^6\) Recital 24 of EMIR specifically requires that ESMA should take account of the impediments facing covered bond issuers and cover pools when developing the RTS.
\(^7\) We would expect that most securitisation vehicles will be non-financial counterparties that fall below the clearing threshold (“NFC-entities”). The clearing threshold is €3 billion in gross notional value for interest rate derivative contracts and the same with respect to foreign exchange derivative contracts.
Margin Requirements

Variation Margin

It is proposed that Counterparties will be required to collect variation margin on a daily basis from the business day that follows the date that an uncleared OTC derivative contract is executed. The amount of variation margin that is required to be posted shall be a function of each contract’s mark-to-market valuation (which is also required to be determined by Counterparties on a daily basis in accordance with Article 11(2) of EMIR).

Initial Margin

Counterparties will be required to collect initial margin by no later than the business day following the execution of an uncleared OTC derivatives contract. To do this, they must agree, in writing (or other equivalent permanent electronic means), on a method used to calculate such initial margin. This can either be the Standardised Method set out in the RTS (at Annex IV), or via use of an initial margin model (“IMM”). An IMM can be developed by the counterparties or by a third-party, in either case provided that it complies with certain conditions as specified in the RTS.

The Standardised Method

The Standardised Method operates by breaking down derivatives contracts entered into between two Counterparties into “netting-sets”. This is not a new concept and is derived from the Capital Requirements Regulation8. It refers to a group of transactions between an institution and a single counterparty that is subject to a legally enforceable bilateral netting arrangement. Counterparties are required to take the notional amounts (or underlying values) of each derivative contract within a netting-set and multiply them by an ‘add-on factor’ determined by the categorisation of each derivative (based on its underlying asset class), as set out in the RTS (e.g., the commodities add-on factor is 15%, FX is 6% and equity is 15%). Provisions are made for circumstances where a particular derivative falls into more than one category. The gross-initial margin of a netting-set is determined by adding together the resulting values from each derivative in that netting-set. A Counterparty’s initial margin requirements (net-initial margin) can then be calculated, by application of a formula, using its gross-initial margin as one of the inputs.

Initial Margin Models

The application of IMMs is not new to the derivatives industry. However, the RTS require that certain key conditions must be met, including assumed variations of valuations within a netting-set calibrated to a 99% confidence interval over a risk horizon of 10 days, a requirement that at least 25% of the data used in the model must be ‘stressed data’ (i.e., data deemed representative of a period of significant financial stress) and the model must capture all the risk drivers (e.g., exposure to interest rate, FX and correlation risk) relevant to the particular netting-set. In addition, the IMM must be subject to back-testing, it must be recalibrated every six months and is subject to governance processes and independent auditing that continually assess and test the effectiveness of the model.

Eligible Collateral

The RTS requires that for assets to be deemed eligible for margining purposes, they must be sufficiently liquid, not exposed to excessive credit, market or FX risk, and hold their value during times of financial stress. As such, although the RTS contains an extensive list of potentially eligible collateral that can be used as both initial and variation margin, there is also a list of additional eligibility criteria that must be satisfied in order to determine if

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8 Article 272(4) of Regulation (EU) 575/2013
any particular items on the list can be posted. That said, the list of eligible collateral is noticeably broader than the
one provided for in the BSCS/ISCO Standards. In particular, in addition to the more traditional use of cash and
government issued debt, the RTS provide for the possible use of senior tranches of securitisations, as well as
certain quoted shares and units in UCITS funds.

Wrong-Way Risk

In order to avoid ‘wrong-way risk’ (i.e., the risk that an entity’s exposure increases as the probability of its
counterparty’s default increases), the RTS provides that posted collateral must not have been issued by the posting
Counterparty (i.e., an entity cannot provide its own bonds as margin for a transaction) or by entities which are
part of the same group of the posting Counterparty.

Concentration Limits

Given all the collateral that may potentially have to be posted as a consequence of these rules, one concern for the
ESAs in preparing the RTS is that there is a risk that particular counterparties could become overly exposed to
particular assets or issuers. As a consequence, the RTS provide for diversification requirements, intended to
ensure that Counterparties cannot collect more than a certain amount of collateral from any one particular source
and therefore, during times of economic stress, are less likely to have to liquidate significant individual positions.
This could, however, create difficulty for Counterparties who post smaller amounts of collateral, since
operationally it could be more problematic for them to break up their margin requirements into multiple forms of
collateral from different issuers. It remains to be seen how this issue will be addressed by the ESAs.

Operational Requirements

Counterparties must put ‘robust risk management procedures’ in place, which shall include (amongst other
things) policy and procedures regarding the exchange of collateral (covering collateral levels, types and eligibility
and details of applicable haircuts), processes for escalating disputes with counterparties and reporting material
exceptions to senior management, as well as procedures and controls ensuring the timely notification of margin
calls, measuring and mitigating risks arising from accepted collateral assets and verifying the liquidity of eligible
collateral.

Segregation

All collateral that is collected in the form of initial margin is required to be segregated from proprietary assets on
the books and records of the custodian (or third-party) that is holding it. The collecting Counterparty must,
however, offer the posting Counterparty the right to segregate the collateral also from the assets of other posting
Counterparties (individual segregation).

Re-Hypothecation

Counterparties that collect initial margin are prohibited from re-hypothecating, re-pledging or otherwise re-using
the collateral. The ESAs concern is that where collateral is re-hypothecated, this could result in third-parties
obtaining a legal or beneficial entitlement to that collateral. This potentially dilutes the effectiveness of its role in
reducing overall systemic risk, since the counterparty runs the risk of its margin being trapped by that third party,
in the event of the re-hypothecator's default. This is a slightly more restrictive approach than provided for in the
BSCS/ISCO Standards, where re-hypothecation would be allowed, subject to a stringent set of conditions. Since
the ESAs have concerns that such conditions could result in technical and legal issues, the stricter approach has
been taken in the RTS. However, market participants have been asked to provide feedback on this issue. Given the
importance of re-hypothecation to the market and to prime brokers in particular, it remains to be seen where the
final rules will come out.
Intra-Group Contracts

In accordance with Article 11(3) of EMIR, intragroup transactions can be subject to exemption from the collateralisation rules, provided certain conditions are met. These are that (i) risk management procedures must be sound, robust and consistent with the complexity of derivatives transactions; and (ii) there must not be any practical or legal impediments to the transfer of funds or repayment of liabilities between Counterparties. However, any such exemption is subject to a decision of the competent authority(ies) governing the two connected Counterparties. As such, the RTS set out detailed procedures that such Counterparties are required to follow in order to avail themselves of any such exemption.

Phase-in and Next Steps

The requirements set out in the RTS are not proposed to come into force until December 1, 2015. However, given the ESAs’ desire to implement the RTS on a proportionate basis (giving smaller market participants additional time to develop the systems necessary to implement the RTS), only market participants who trade, in aggregate, non-centrally cleared OTC derivatives exceeding €3 trillion in aggregate notional amount (taking into account the notional amount of trades outstanding at month-end), will be subject to the requirements from that date. This threshold will be substantially reduced, however, so that as from December 1, 2019, it will capture entities that are part of any group with aggregate trades in excess of €8 billion in notional amount.

The consultation paper is open to comments until July 14, 2014, after which the ESAs will finalise the RTS and submit them to the European Commission before the end of 2014.

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