

Client Alert

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CFTC Issues Final Rules Regarding the Cross-Border Application of its Uncleared Swaps Margin Requirements

By Julian Hammar

On May 24, 2016, the Commodity Futures Trading Commission (“CFTC”) in a much anticipated action approved the issuance of final rules (“Final Rules”) regarding the cross-border application of its uncleared swaps margin requirements that it adopted on December 16, 2015. The Final Rules are closely aligned with the cross-border rules for uncleared swaps margin that the Prudential Regulators¹ adopted in October of 2015 for swap dealers and major swap participants subject to their supervision.² The CFTC’s Final Rules, which were published in the Federal Register on May 31, 2016, are scheduled to become effective on August 1, 2016.³

I. BACKGROUND

In December of 2015, the CFTC adopted final rules (“December 2015 Final Margin Rules”) regarding margin requirements for uncleared swaps for swap dealers and major swap participants that do not have a Prudential Regulator (“Covered Swap Entities” or “CSEs”). The rules that became the December 2015 Final Margin Rules had been re-proposed in October of 2014 (along with those of the Prudential Regulators) to take into account recommendations of the Basel Committee on Bank Supervision (“BCBS”) and the Board of the International Organization of Securities Commissions (“IOSCO”) (referred to herein as the “BCBS/IOSCO Standards”).⁴ The CFTC’s October 2014 re-proposal did not include proposed rules regarding the cross-border application of these rules; instead, the October 2014 re-proposal included an advance notice of proposed rulemaking requesting comment on three alternative approaches.

Subsequently, in June of 2015, the CFTC separately proposed rules regarding the cross-border application of its uncleared swaps margin rules (“Proposed Rules”). The Proposed Rules by their terms would apply the uncleared swap margin rules at the entity level, meaning that they would apply to CFTC-registered swap dealers or major swap participants—as entities—that do not have a Prudential Regulator. However, certain uncleared swaps would be eligible for substituted compliance or excluded from the CFTC’s margin rules entirely under the Proposed Rules based on the counterparties’ relationship to the United States relative to other jurisdictions.⁵

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

² See Margin and Capital Requirements for Covered Swap Entities; Final Rule, 80 Fed. Reg. 74,839 (Nov. 30, 2015).

³ See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants—Cross-Border Application of the Margin Requirements, 81 Fed. Reg. 34,817 (May 31, 2016), available [here](#).

⁴ See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants; Final Rule, 81 Fed. Reg. 635 (Jan. 6, 2016). For more information regarding the CFTC’s December 2015 Final Margin Rules, please see our client alert [here](#).

⁵ For more information regarding the Proposed Rules, please see our client alert [here](#).

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II. FINAL RULES

The Final Rules generally are the same as the Proposed Rules with a few modifications that are described in this client alert. In general, as under the Proposed Rules, the Final Rules provide for the applicability of the CFTC Margin Rules depending upon the location of the counterparties to an uncleared swap and the nexus of the counterparties to the United States. As discussed in greater detail below, where the covered swap entity is a U.S. CSE or a CSE guaranteed by a U.S. person, the uncleared swaps margin rules apply to a greater extent than to a non-U.S. CSE that is not guaranteed by a U.S. person, whose swaps may in certain circumstances be excluded from the rules.

A. Application of the Margin Rules to U.S. CSEs and U.S.-Guaranteed CSEs

Under the Final Rules, the uncleared swaps margin requirements will generally apply to all uncleared swaps of a U.S. CSE and a non-U.S. CSE that is guaranteed by a U.S. person (“U.S. Guaranteed CSE”), without exclusion. Substituted compliance (*i.e.*, compliance with a non-U.S. regulator’s rules that the CFTC has determined to be sufficiently comparable to meet the CFTC’s uncleared swaps margin requirements, discussed in section C. below) would be available in one circumstance only: with respect to initial margin posted to (but not collected from) any non-U.S. person counterparty (including any non-U.S. CSE) whose obligations are not guaranteed by a U.S. person. The CFTC believes that, with regard to a non-U.S. counterparty whose swap obligations are not guaranteed by a U.S. person, in the interest of comity substituted compliance in these circumstances would be reasonable. The CFTC’s rules afford U.S. CSEs and U.S. Guaranteed CSEs the same treatment as under the Prudential Regulators’ final uncleared swaps margin rules, which provide for the possibility of substituted compliance for U.S. CSEs and U.S. Guaranteed CSEs with regard to the posting of initial margin to non-U.S. counterparties.⁶

B. Application of Margin Rules to Non-U.S. CSEs that are Not Guaranteed by a U.S. Person

1. Availability of Substituted Compliance

The Final Rules would allow non-U.S. CSEs that are not guaranteed by a U.S. person to avail themselves of substituted compliance with non-U.S. uncleared swaps margin rules for swaps with any counterparty, except for a U.S. CSE or U.S. Guaranteed CSE. Notably, the availability of substituted compliance under the Final Rules is broader than under the CFTC’s Cross-Border Guidance issued by the agency in 2013,⁷ which would have applied the CFTC’s margin requirements to swaps between non-U.S. swap dealers and all U.S. persons, with substituted compliance available only for swaps between a non-U.S. swap dealer and a foreign branch of a U.S. swap dealer.

The availability of substituted compliance under the Final Rules also applies to a non-U.S. CSE not guaranteed by a U.S. person that is consolidated for accounting purposes with an ultimate parent entity that is a U.S. person, described in the rules as a “Foreign Consolidated Subsidiary” (“FCS”). For this purpose, the term “ultimate parent entity” means an entity in a consolidated group in which none of the other entities in the group has a controlling

⁶ See 80 Fed. Reg. at 74,885.

⁷ See Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations, 78 Fed. Reg. 45,291 (July 26, 2013) (“Cross Border Guidance”).

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interest in accordance with U.S. Generally Accepted Accounting Principles. While eligible for substituted compliance, FCSs, as well as U.S. branches of non-U.S. CSEs, are not eligible for the exclusion from the uncleared swaps margin rules for non-U.S. CSEs described in section B.2. below.

If the swap obligations of a non-U.S. CSE (including an FCS or U.S. branch of a non-U.S. CSE) are not guaranteed by a U.S. person, and its counterparty is a U.S. CSE or a U.S. Guaranteed CSE (including an FCS or U.S. branch of a non-U.S. CSE the swap obligations of which are guaranteed by a U.S. person), substituted compliance would be available only with respect to initial margin collected from the U.S. CSE or U.S. Guaranteed CSE, and in no other circumstances.

2. Exclusion from Margin Rules

The Final Rules provide for an exclusion from the CFTC's uncleared swaps margin rules with respect to swaps entered into by a non-U.S. CSE with a non-U.S. person, provided that neither the non-U.S. CSE's nor the non-U.S. person's swap obligations are guaranteed by a U.S. person, and neither counterparty is an FCS or a U.S. branch of a non-U.S. CSE.⁸ In a new provision not contained in the Proposed Rules, the Final Rules provide, in connection with inter-affiliate swaps that under the December 2015 Final Margin Rules are exempt from the uncleared swaps margin requirements under certain conditions, that this exclusion is not available if (i) the market-facing transaction of the non-U.S. CSE (that is otherwise eligible for the exclusion) is not subject to comparable initial margin collection requirements in the home jurisdiction and (ii) any of the risk associated with the uncleared swap is transferred, directly or indirectly, through inter-affiliate transactions, to a U.S. CSE.⁹

C. Procedures for Substituted Compliance Determinations

The Final Rules will permit a U.S. CSE or a non-U.S. CSE in the circumstances described above that is eligible for substituted compliance to comply with the margin requirements of the relevant foreign jurisdiction in lieu of compliance with the CFTC's margin requirements, only if the CFTC makes a comparability determination to the effect that such jurisdiction's margin requirements are comparable to the CFTC's margin requirements. Persons eligible to request a comparability determination include any CSE that is eligible for substituted compliance and any foreign regulatory authority that has direct supervisory authority over one or more CSEs and that is responsible for administering the relevant foreign jurisdiction's margin requirements. Such persons may request a comparability determination individually or collectively and with respect to some or all of the CFTC's margin requirements; the CFTC advises that eligible CSEs may wish to coordinate with their home regulators and other CSEs to streamline the process.

A comparability determination applicant must submit (i) copies of the relevant foreign jurisdiction's margin requirements, (ii) a description of their objectives, (iii) a description of how they differ from the BCBS/IOSCO standards, and (iv) a description of how they address the elements of the CFTC's margin requirements, as well as any other documentation the CFTC deems relevant.¹⁰ The CFTC will issue a comparability determination to the

⁸ See 17 CFR 23.160(b)(2)(ii).

⁹ See 17 CFR 23.160(b)(2)(ii)(B).

¹⁰ See 17 CFR 23.160(c)(2).

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extent that it determines that some or all of the relevant foreign jurisdiction's margin requirements are comparable to the CFTC's corresponding margin requirements. In making a comparability determination, the Final Rules provide that the CFTC will consider all relevant factors, including: (i) the scope and objectives of the relevant foreign jurisdiction's margin requirements, (ii) whether the relevant foreign jurisdiction's margin requirements achieve comparable outcomes to the Commission's corresponding margin requirements, (iii) the ability of the relevant regulatory authority or authorities to supervise and enforce compliance with the relevant foreign jurisdiction's margin requirements, and (iv) any other facts and circumstances the CFTC deems relevant.¹¹ The CFTC will also consider the consistency of the margin requirements of the foreign jurisdiction with the BCBS/IOSCO Standards, although the CFTC states that, while a finding of consistency with the BCBS/IOSCO Standards is necessary, it may not be sufficient for a finding of comparability.¹²

The CFTC describes its comparability standard as "outcome-based" with a focus on whether margin requirements in the foreign jurisdiction achieve the same regulatory objectives as margin requirements under the Commodity Exchange Act without regard to whether the foreign jurisdiction has implemented specific rules that are identical to the CFTC's rules. The standard takes the form of an "element-by-element" determination involving 12 elements, where the CFTC may find some elements comparable with its rules, but not others.¹³ In a dissenting statement to the Final Rules, CFTC Commissioner J. Christopher Giancarlo expressed the view that this approach is impractical, unnecessary, and contrary to the spirit of the 2009 G-20 Pittsburgh Accords and the BCBS/IOSCO standards, and that a better approach would be to determine whether, in the aggregate, a foreign regulator has adopted the BCBS-IOSCO standards.¹⁴ It remains to be seen how the CFTC will apply its standard in an actual comparability determination.

D. Definition of U.S. Person

As under the Proposed Rules, the Final Rules' definition of U.S. person differs from the U.S. person definition in the CFTC's 2013 Cross-Border Guidance, which is generally applicable to Dodd-Frank Title VII CFTC requirements. While broadly similar in most respects, key differences adopted by the Final Rules include:

- Elimination of the "including, but not limited" language contained in the U.S. person definition in the Cross-Border Guidance. This change provides greater legal certainty for market participants as to who is (and who is not) a U.S. person.

¹¹ See 17 CFR 23.160(c)(3).

¹² 81 Fed. Reg. at 34,837.

¹³ The twelve elements generally are similar to the elements as proposed, except one element, the treatment of inter-affiliate derivative transactions, has been added. The twelve elements are as follows: (A) The products subject to the foreign jurisdiction's margin requirements; (B) The entities subject to the foreign jurisdiction's margin requirements; (C) The treatment of inter-affiliate derivative transactions; (D) The methodologies for calculating the amounts of initial and variation margin; (E) The process and standards for approving models for calculating initial and variation margin models; (F) The timing and manner in which initial and variation margin must be collected and/or paid; (G) Any threshold levels or amounts; (H) Risk management controls for the calculation of initial and variation margin; (I) Eligible collateral for initial and variation margin; (J) The requirements of custodial arrangements, including segregation of margin and rehypothecation; (K) Margin documentation requirements; and (L) The cross-border application of the foreign jurisdiction's margin regime. See 17 CFR 23.160(c)(2)(ii).

¹⁴ See generally 81 Fed. Reg. at 34,853-54.

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- Elimination of the U.S. majority ownership prong that was included in the Cross-Border Guidance definition for funds or other collective investment vehicles. Market participants commented that this requirement is burdensome and difficult to comply with.
- Elimination of the requirement that a legal entity owned by one or more U.S. person(s), for which such person(s) bear unlimited responsibility for its obligations and liabilities, be majority owned by one or more U.S. persons.¹⁵

It is likely that the final definition of U.S. person will be welcomed by market participants, as it eliminates aspects of the Cross-Border Guidance definition that created legal uncertainty and were burdensome to implement. However, it should be noted that, while similar to the Prudential Regulators' rules, the CFTC's definition of U.S. person includes two types of entities that are not mentioned in the Prudential Regulators' rules: (i) an entity with its principal place of business in the United States and (ii) an entity for which a U.S. person bears unlimited responsibility for the entity. This may mean, in practice, that the CFTC's uncleared swaps margin rules will apply in more situations than the Prudential Regulators' rules.

E. Definition of Guarantee

For purposes of the Final Rules, a guarantee is not as broadly defined as it is in the CFTC's Cross-Border Guidance. The Final Rules would define the term "guarantee" as an arrangement, pursuant to which one party to an uncleared swap transaction with a non-U.S. counterparty has rights of recourse against a U.S. person guarantor (whether such guarantor is affiliated with the non-U.S. counterparty or is an unaffiliated third party) with respect to the non-U.S. counterparty's obligations under the swap. A party has rights of recourse against a U.S. guarantor if the party has a conditional or unconditional legally enforceable right, in whole or in part, to receive payments from, or otherwise collect from, the U.S. person in connection with the non-U.S. person's obligations under the swap. The terms of the guarantee need not be included with the swap documentation or reduced to writing so long as legally enforceable rights are created under the laws of the relevant jurisdiction.¹⁶

¹⁵ The final definition of the term U.S. person in the Final Rules is as follows:

- (i) A natural person who is a resident of the United States;
- (ii) An estate of a decedent who was a resident of the United States at the time of death;
- (iii) A corporation, partnership, limited liability company, business or other trust, association, joint-stock company, fund or any form of entity similar to any of the foregoing (other than an entity described in paragraph (a)(10)(iv) or (v) of this section) (a "legal entity"), in each case that is organized or incorporated under the laws of the United States or having its principal place of business in the United States, including any branch of such legal entity;
- (iv) A pension plan for the employees, officers or principals of a legal entity described in paragraph (a)(10)(iii) of this section, unless the pension plan is primarily for foreign employees of such entity;
- (v) A 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) A 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 owned by one or more persons described in paragraphs (a)(10)(i) through (v) of this section and for which such person(s) bears unlimited responsibility for the obligations and liabilities of the legal entity, including any branch of the legal entity; or
- (vii) An 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 paragraphs (a)(10)(i) through (vi) of this section.

¹⁷ 17 CFR 23.610(a)(10).

¹⁶ See 17 CFR 23.160(a)(2).

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The Final Rules add a provision to the definition of the term guarantee not contained in the Proposed Rules, which provides that, in the case of any arrangement pursuant to which the guarantor has a conditional or unconditional legally enforceable right to receive or otherwise collect, in whole or in part, payments from any other guarantor with respect to the counterparty's obligations under the uncleared swap, such arrangement will be deemed a guarantee of the counterparty's obligations under the uncleared swap by the other guarantor. This provision conforms the CFTC's definition of the term guarantee to that of the Prudential Regulators in their final margin rules. Notwithstanding this modification, the Final Rules' definition of the term guarantee is generally narrower than that in the Cross-Border Guidance because it does not include other types of financial arrangements, such as keepwells and liquidity puts, certain types of indemnity agreements, master trust agreements, liability, or loss transfer or sharing agreements.

F. Reliance on Counterparty Representations

The Final Rules expands the circumstances under which market participants may reasonably rely on written representations with respect to the status of their counterparties compared with the Proposed Rules. Under the Final Rules, a market participant may reasonably rely on a counterparty's written representation of its status as a U.S. person, FCS, or a non-U.S. person whose obligations are guaranteed by a U.S. person, unless the market participant has information that would cause a reasonable person to question the accuracy of the representation.¹⁷ By contrast, the Proposed Rules would have permitted reliance on a counterparty's representation only in the case of representing its status as a U.S. person (and not as an FCS or whether the obligations of the counterparty are guaranteed by a U.S. person).

G. Special Provisions for Non-Segregation and Non-Netting Jurisdictions

In order to conform the CFTC's uncleared swaps margin rules to those of the Prudential Regulators, the Final Rules add two provisions similar to the Prudential Regulators' Rules to address non-segregation and non-netting foreign jurisdictions. Specifically, the first provision addresses swaps with counterparties in foreign jurisdictions where limitations in the legal or operational infrastructure of the jurisdiction make it impracticable to comply with the custodial arrangement requirements contained in the December 2015 Final Margin Rules. Subject to conditions, an FCS or a foreign branch of a U.S. CSE transacting with counterparties in such jurisdictions need not comply with either the requirement to post initial margin or the custodial arrangement requirements that pertain to initial margin collected by a CSE under the December 2015 Final Margin Rules.¹⁸ The second provision addresses the situation where a CSE cannot conclude, with a well-founded basis, that a netting agreement with a counterparty in a foreign jurisdiction meets the definition of an "eligible master netting agreement" set forth in the December 2015 Final Margin Rules. The provision provides that a CSE may net uncleared swaps in such

¹⁷ See 81 Fed. Reg. at 34,827.

¹⁸ See 17 CFR 23.160(e). The conditions include that (i) the CSE's counterparty must be a non-U.S. person that is not a CSE, and the counterparty's obligations must not be guaranteed by a U.S. person; (ii) the CSE must collect initial margin in cash on a gross basis and post and collect variation margin in cash in accordance with the December 2015 Final Margin Rules; and (iii) for each broad risk category set out in the December 2015 Final Margin Rules (credit, equity, foreign exchange and interest rates, and commodities), the total outstanding notional value of all uncleared swaps in the broad risk category as to which the CSE is relying upon this relief may not exceed 5% of the CSE's total outstanding notional value for all uncleared swaps in that same broad risk category. In addition, the CSE must have policies and procedures to ensure compliance with the requirements of the exception and maintain books and records documenting that the requirements are satisfied. See 81 Fed. Reg. at 34,833.

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circumstances in determining the amount of initial and variation margin that it posts, provided that certain conditions are met.¹⁹

III. CONCLUSION

Certain aspects of the CFTC's Final Rules may be viewed favorably by market participants, including the greater legal certainty provided for in the U.S. person definition, the expansion (as compared with the CFTC's Cross-Border Guidance) of the scope for potential substituted compliance determinations and the broadened number of situations where counterparty representations may be relied upon. However, much of the Final Rules' impact on market participants may depend upon how the substituted compliance determination process is implemented, which, although labeled an "outcomes-based" approach, may not achieve that objective with its element-by-element determinations in practice. The element-by-element determinations may also result in findings that some foreign margin requirements are comparable, but not others, leading to the potential for a complex patchwork of U.S. and non-U.S. requirements to apply to cross-border swap transactions, which may greatly increase the compliance burden and cost for market participants.

Contact:

Julian Hammar

(202) 887-1679

jhammar@mofo.com**James Schwartz**

(212) 336-4327

jschwartz@mofo.com**Chrys Carey**

(202) 887-8770

ccarey@mofo.com**David Kaufman**

(212) 468-8237

dkaufman@mofo.com

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Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations. Prior results do not guarantee a similar outcome.

¹⁹ See 17 CFR 23.160(d). These conditions are that the CSE must treat uncleared swaps covered by the agreement on a gross basis in determining the amount of initial and variation margin that it must collect and that the CSE have policies and procedures to ensure, and maintain books and records to document, compliance with the requirements of 17 CFR 23.160(d).

Cross-Border Application of Uncleared Swaps Margin Requirements under CFTC Final Rules

Covered Swap Entity (“CSE”)	Counterparty	Cross-Border Application of Margin Requirements
<ul style="list-style-type: none"> • U.S. CSE or • Non-U.S. CSE (including U.S. branch of a non- U.S. CSE or a Foreign Consolidated Subsidiary (“FCS”)) whose obligations under the relevant swap are guaranteed by a U.S. person. 	<p>Any (except for a non-U.S. person whose swap obligations are not guaranteed by a U.S. person as noted immediately below).</p>	<p>CFTC Margin Rules apply.</p>
<ul style="list-style-type: none"> • U.S. CSE or • Non-U.S. CSE (including a U.S. branch of a non-U.S. CSE or an FCS) whose obligations under the relevant swap are guaranteed by a U.S. person. 	<p>Non-U.S. person (including a non-U.S. CSE, FCS, or U.S. branch of a non-U.S. CSE) whose swap obligations are not guaranteed by a U.S. person.</p>	<ul style="list-style-type: none"> • CFTC Margin Rules generally apply • Substituted compliance may be available for the posting of initial margin by the CSE.
<p>Non-U.S. CSE that is not:</p> <ul style="list-style-type: none"> • an FCS of a U.S. person or • a U.S. branch of a non-U.S. CSE, and <p>whose obligations under the swap are not guaranteed by a U.S. person.</p>	<p>Non-U.S. person counterparty (including a non-U.S. CSE but not:</p> <ul style="list-style-type: none"> • an FCS or • a U.S. branch of a non-U.S. CSE), and <p>whose obligations under the swap are not guaranteed by a U.S. person</p>	<p>CFTC Margin Rules do not apply (except in connection with certain inter-affiliate swaps).</p>
<ul style="list-style-type: none"> • Non-U.S. CSE that is not an FCS and whose swaps are not guaranteed by a U.S. person or • Non-U.S. CSE whose obligations under a swap are not guaranteed by a U.S. person, but which is an FCS or a U.S. branch of the non-U.S. CSE. 	<ul style="list-style-type: none"> • U.S. CSE or • Non-U.S. CSE (including U.S. branch of a non-U.S. CSE or an FCS) whose swap obligations are guaranteed by a U.S. person). 	<ul style="list-style-type: none"> • CFTC Margin Rules apply. • Substituted compliance may be available for collection of initial margin by the non-U.S. CSE.
<ul style="list-style-type: none"> • Non-U.S. CSE that is not an FCS and whose swaps are not guaranteed by a U.S. person or • Non-U.S. CSE whose obligations under a swap are not guaranteed by a U.S. person, but which is an FCS or a U.S. branch of the non-U.S. CSE. 	<ul style="list-style-type: none"> • U.S. person (except as noted above for a U.S. CSE). • Non-U.S. person whose swap obligations are guaranteed by a U.S. person (except a non-U.S. CSE, U.S. branch of a non-U.S. CSE, or FCS whose obligations are guaranteed as noted above). • Non-U.S. CSE, U.S. branch of a non-U.S. CSE or foreign consolidated subsidiary whose obligations are not guaranteed by a U.S. person. 	<p>Substituted compliance may be available for all requirements.</p>