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# U.S. Uncleared Swap Margin, Capital and Segregation Rules

January 21, 2016



**Davis Polk**

Davis Polk & Wardwell LLP

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# Introduction

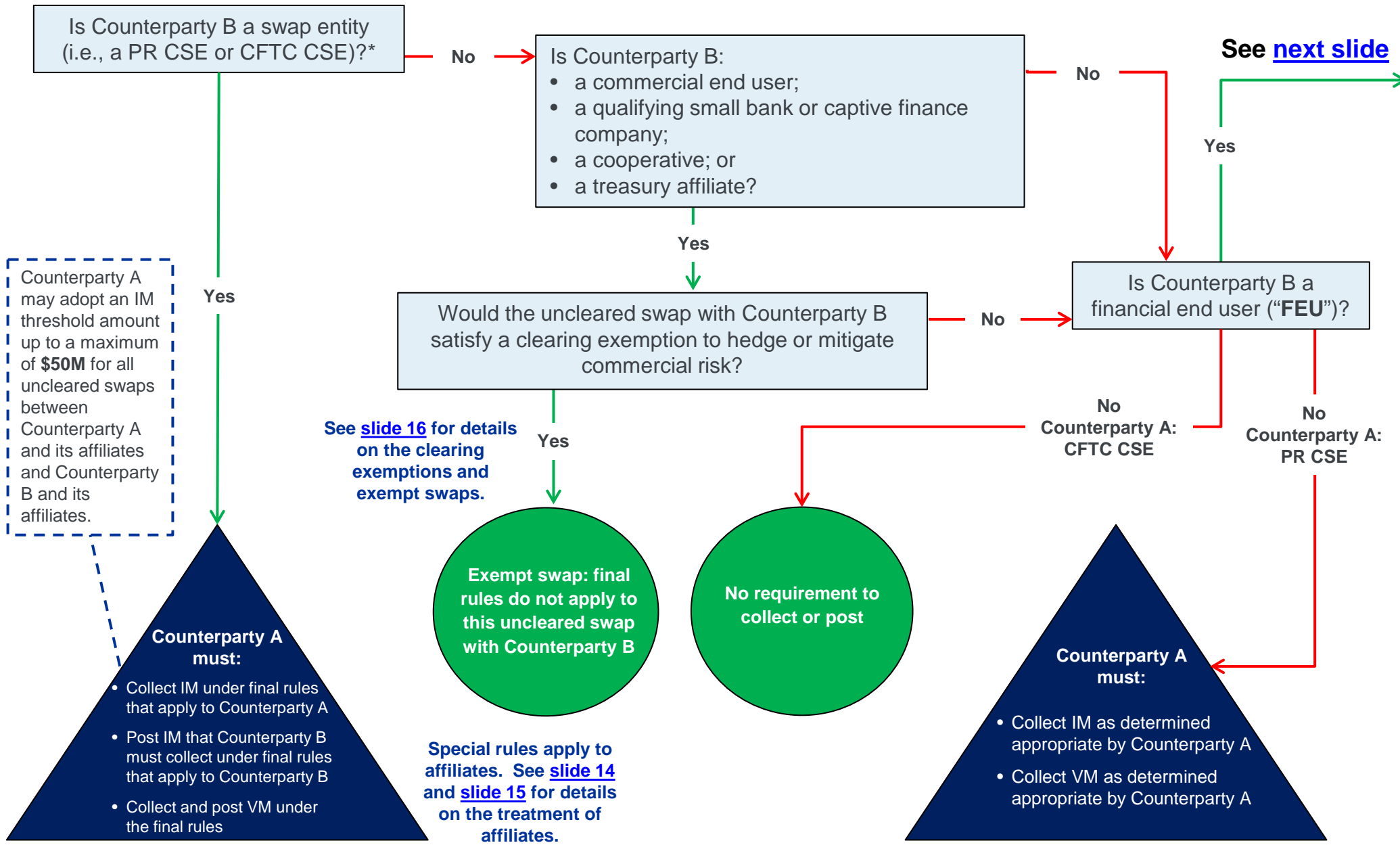
- [U.S. prudential regulators](#) (the OCC, Federal Reserve, FDIC, FCA and FHFA) and the [CFTC](#) have finalized uncleared swap margin, capital and segregation requirements (the “**PR rules**,” and “**CFTC rules**,” respectively, and the “**final rules**,” collectively).\* The PR rules apply to swap entities that are prudentially regulated by a U.S. prudential regulator (“**PR CSEs**”). The CFTC rules apply to swap entities that are regulated by the CFTC and that are not prudentially regulated (“**CFTC CSEs**”). In this memorandum, “**covered swap entities**” refers to PR CSEs and CFTC CSEs, together.
  - The [SEC](#) has proposed, but not yet finalized, uncleared swap margin and capital rules that would apply to security-based swap dealers and major security-based swap participants not prudentially regulated by a U.S. prudential regulator.
- The final rules are broadly similar to the Basel Committee on Banking Supervision’s and the International Organization of Securities Commissions’ 2013 [final policy framework](#) on margin requirements for uncleared derivatives (as modified in March 2015).
- The variation margin compliance deadline for a given covered swap entity and counterparty is either September 1, 2016 or March 1, 2017, and the initial margin compliance deadline is phased in between September 1, 2016 and September 1, 2020, each depending upon the size of the covered swap entity’s (and its affiliates’) combined swap positions with the counterparty. See [slide 17](#) for more information on compliance timing.



# Application of the Final Rules

<b>CFTC CSE:</b>	covered swap entity subject to CFTC rules
<b>FEU:</b>	financial end user
<b>IM:</b>	initial margin
<b>MSE:</b>	material swaps exposure
<b>PR CSE:</b>	covered swap entity subject to PR rules
<b>VM:</b>	variation margin

These flowcharts describe the uncleared swap margin rules applicable to Counterparty A, a swap entity subject to the PR or CFTC rules, when entering into swaps with Counterparty B.



\* If Counterparty A is a CFTC CSE and Counterparty B is a security-based swap dealer, Counterparty B should be treated as an FEU and not as a swap entity.

# Application of the Final Rules (cont.)

<b>CFTC CSE:</b>	covered swap entity subject to CFTC rules
<b>FEU:</b>	financial end user
<b>IM:</b>	initial margin
<b>MSE:</b>	material swaps exposure
<b>PR CSE:</b>	covered swap entity subject to PR rules
<b>VM:</b>	variation margin

From [previous slide](#)

Does Counterparty B have material swaps exposure (“MSE”)?

No

Yes

Is Counterparty B an affiliate of Counterparty A?

No

Yes

**Non-Affiliate FEU with MSE**

**Affiliate FEU with MSE**

**FEU without MSE**

Counterparty A may adopt an IM threshold amount, up to a maximum of **\$50M**, for all uncleared swaps between Counterparty A and its affiliates and Counterparty B and its affiliates.

PR CSEs may adopt a maximum IM threshold amount of **\$20M** per affiliate pair.

See [slide 4](#) and [slide 5](#) for the definitions of FEU and MSE.

**Counterparty A must:**

- Collect and post IM under final rules
- Collect and post VM under final rules

**Counterparty A must:**

- If a PR CSE, collect, but not required to post, IM under PR rules
- If a CFTC CSE, not required to collect or post IM under CFTC rules, provided conditions are met
- Collect and post VM under final rules

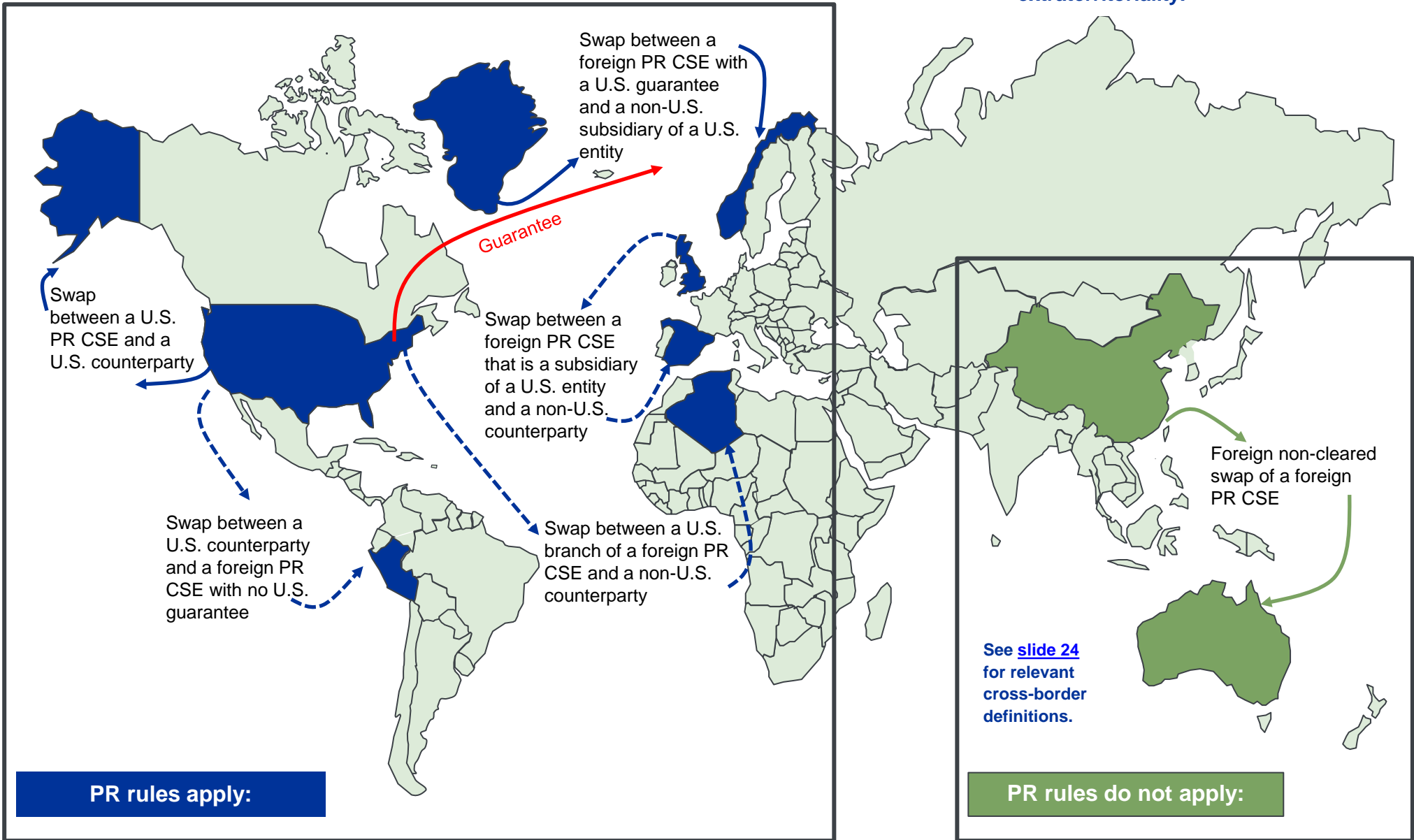
See [slide 14](#) and [slide 15](#) on the treatment of inter-affiliate swaps.

**Counterparty A must:**

- If a PR CSE, collect IM as determined appropriate by Counterparty A
- If a CFTC CSE, not required to collect or post IM
- Collect and post VM under final rules

# Examples of Cross-Border Application of the PR Rules\*

See [slides 24 to 26](#) for details on extraterritoriality.



See [slide 24](#) for relevant cross-border definitions.

\* As of the date of this memorandum, the CFTC has not issued final rules addressing the cross-border application of its margin requirements.

# More Details on the Final Rules

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# User Guide

## TERMINOLOGY USED IN THIS VISUAL MEMORANDUM

This memorandum uses “#” and “‡” to indicate instances where the PR rules and CFTC rules employ different definitions of fundamental terms that substantively affect the application of the final rules.

- **Status of Security-Based Swap Dealers.** Under the PR rules, a security-based swap dealer is a swap entity, while under the CFTC rules, a security-based swap dealer is a financial end user.

In this memorandum:

- “Swap entity<sup>#</sup>” means a Counterparty B that (i) under the PR rules is a swap dealer, security-based swap dealer, major swap participant or major security-based swap participant, and (ii) under the CFTC rules is a swap dealer or major swap participant, where such distinction is relevant.\*
- Where a provision applies to a Counterparty A swap entity under the PR rules or the CFTC rules, but not both, we will specify; otherwise, Counterparty A is referred to simply as a covered swap entity.
- “Financial end user<sup>#</sup>” under the PR rules does not include security-based swap dealers. “Financial end user<sup>#</sup>” under the CFTC rules includes security-based swap dealers.

- **Scope of Products.** The PR rules apply the margin requirements to uncleared swaps and uncleared security-based swaps, whereas the CFTC rules apply the margin requirements only to uncleared swaps. In this memorandum:

- “Uncleared swap<sup>‡</sup>” under the PR rules means: uncleared swap and uncleared security-based swap. “Uncleared swap<sup>‡</sup>” under the CFTC rules means: uncleared swap. Where that is not the case, we will specify.\*\*

\* Hereinafter, “swap dealer” includes major swap participant, and “security-based swap dealer” includes major security-based swap participant.

\*\* Similar treatment applies to “exempt swaps<sup>‡</sup>”.

# Key Distinctions Between the Final Rules

- The CFTC rules differ from the PR rules in the following significant ways:
  - The CFTC rules apply only to uncleared swaps (not security-based swaps), whereas the PR rules apply to uncleared swaps and uncleared security-based swaps;
  - The CFTC rules classify a security-based swap dealer as a financial end user, whereas the PR rules classify a security-based swap dealer as a swap entity;
  - The CFTC rules do not require a CFTC CSE to collect or post initial or variation margin from counterparties that are not swap entities or financial end users, whereas the PR rules require a PR CSE to collect and post initial and variation margin from “other counterparties” as determined appropriate by the PR CSE;
  - The CFTC rules do not require a CFTC CSE to collect or post initial margin from an affiliate, provided the affiliate meets certain requirements (described on [slide 15](#)), whereas the PR rules require a PR CSE to collect initial margin from, but not post initial margin to, an affiliate;
  - A PR CSE trading under a netting agreement that is not an eligible master netting agreement (an “**EMNA**”) may post on a net basis, but must collect on a gross basis. A CFTC CSE trading under a netting agreement that is not an EMNA must collect and post on a gross basis; and
  - The CFTC rules permit the National Futures Association (“**NFA**”) to approve initial margin models, whereas the PR rules do not contemplate a role for a self-regulatory organization in approving margin models.



# Counterparty Classifications

## FOUR TYPES OF COUNTERPARTIES

- The final rules divide covered swap entities' counterparties into categories:
  1. swap entities<sup>#</sup>;
  2. financial end users<sup>#</sup> *with* material swaps exposure;
  3. financial end users *without* material swaps exposure; and
  4. sovereign entities, multilateral development banks, the Bank of International Settlements and, with respect to PR CSEs, “other counterparties” not listed in categories 1 through 3 above.
- Whether, and how, margin requirements apply to uncleared swaps<sup>‡</sup> between a covered swap entity and a particular counterparty generally depends upon the type of counterparty, and for a counterparty that is a financial end user<sup>#</sup>, whether it has material swaps exposure.
- **Exempt swaps<sup>‡</sup>.** The final rules do not apply to transactions with commercial end users, qualifying small banks (generally insured depository institutions and credit unions with less than \$10 billion in assets), qualifying captive finance companies, treasury affiliates and certain cooperative entities that would satisfy an applicable clearing exemption. See [slide 16](#) for more detail.

# Counterparty Classifications (cont.)

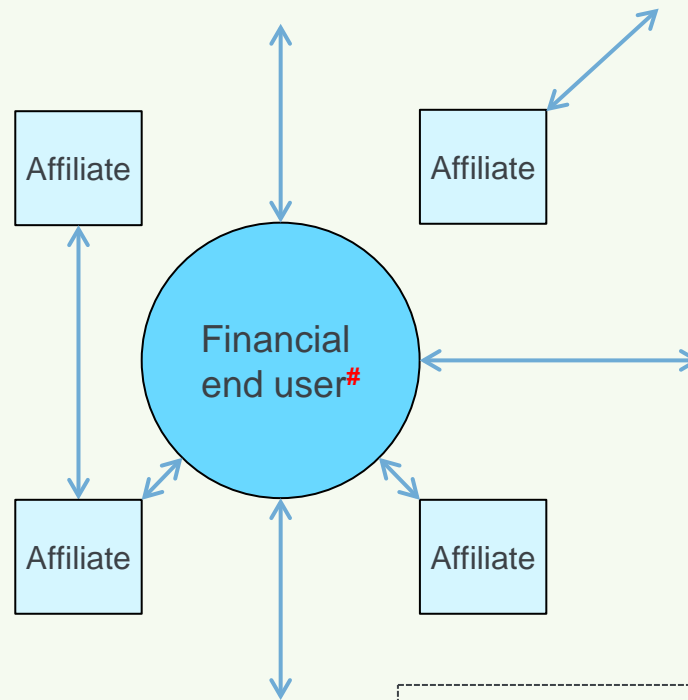
## DEFINITION OF FINANCIAL END USER

- Financial end user is defined broadly to capture entities or persons that are engaged in services or activities, or have sources of income, that are financial in nature. The final rules include an extensive list of entities that would be financial end users. These include:
  - **A bank:** A U.S. or foreign bank; a credit union; a trust or fiduciary company; an IHC, BHC or affiliate; savings and loan company; an industrial loan company
  - **Fannie Mae, Freddie Mac or a Federal Home Loan Bank**
  - **An investment fund:** A registered investment company; a private fund; a vehicle that relies on section 3(c)(5)(c) or Rule 3a-7 under the 1940 Act; a commodity pool; a BDC; an ERISA employee benefit plan
  - **A state-licensed lender:** A state-licensed or registered lender or other state-licensed financial services firm
  - **A market intermediary:** A market intermediary or service provider, including a broker-dealer; investment adviser; CPO; CTA; FCM; IB; floor broker/trader
  - **A non-U.S. entity that would be a financial end user** if it were organized under the laws of the United States or any State
  - **A nonbank SIFI**
  - **An insurance company**
  - **A firm that trades in financial instruments for clients or with its own money:** A person, entity or arrangement that is, or holds itself out as, raising money from investors, accepting money from clients or using its own money primarily to invest, trade or facilitate the investing or trading in loans, securities, swaps, funds or other assets for resale or other trading
  - Under the CFTC rules, a security-based swap dealer
- The full definitions of financial end user<sup>#</sup> are available [here](#).

# Counterparty Classifications (cont.)

## MATERIAL SWAPS EXPOSURE

**Material Swaps Exposure if > \$8 billion**



Material swaps exposure is measured as: the average daily aggregate notional amount of uncleared swaps and uncleared security-based swaps, FX swaps and FX forwards for each business day in June, July and August of the previous year of a financial end user<sup>#</sup> and all of its affiliates to all counterparties, not including exempt swaps and exempt security-based swaps. Uncleared swaps and uncleared security-based swaps with affiliates are counted once.

Uncleared swaps, uncleared security-based swaps, FX swaps and FX forwards: ↔

**Example:** For the period between January 1, 2017 through December 31, 2017, an entity would determine whether it had material swaps exposure with reference to June, July and August of 2016.

- A covered swap entity may reasonably rely on a representation from its counterparty as to whether the counterparty has material swaps exposure.
- FX swaps and FX forwards, although included in the material swaps exposure calculation, are not subject to the margin requirements under the final rules. Further, both uncleared swaps and uncleared security-based swaps must be included in determining material swaps exposure, even under the CFTC rules, where security-based swaps are not subject to the margin requirements.

# Initial and Variation Margin

## OVERVIEW

- Other than for exempt swaps<sup>‡</sup>, initial and variation margin will need to be posted and collected by a covered swap entity based upon a counterparty's classification and the result of the material swaps exposure calculation, as follows:

Counterparty	Initial Margin Requirement	Variation Margin Requirement
Swap entity <sup>#</sup>	Collect <sup>*</sup>	Collect and post
Financial end user <sup>#</sup> <i>with</i> material swaps exposure	Collect and post	Collect and post
Financial end user <i>without</i> material swaps exposure (PR CSEs only)	Collect as determined appropriate by the PR CSE	Collect and post
Financial end user <i>without</i> material swaps exposure (CFTC CSEs only)	No affirmative requirement under CFTC rules	Collect and post
Other counterparty (PR CSEs only)	Collect as determined appropriate by the PR CSE under PR rules	Collect as determined appropriate by the PR CSE under PR rules
Non-financial end user (CFTC CSEs only)	No affirmative requirement under CFTC rules	No affirmative requirement under CFTC rules

\* As a practical matter, swaps between two covered swap entities will require bilateral collecting and posting of initial margin. The amount that a covered swap entity must post is determined by the margin rules applicable to its counterparty. For example, a PR CSE transacting with a CFTC CSE must post the amount its CFTC CSE counterparty is required to collect under the CFTC rules. In addition, the CFTC rules place an affirmative obligation on a CFTC CSE to post initial margin to a PR CSE that is an affiliate of the CFTC CSE, in an amount required to be collected by the PR CSE under the PR rules.

# Initial and Variation Margin (cont.)

## INITIAL MARGIN THRESHOLDS

- **\$50 million initial margin threshold.** A covered swap entity may adopt a maximum initial margin threshold amount of \$50 million, below which it need not collect or post initial margin.
  - The threshold amount applies on a consolidated basis, both to the consolidated covered swap entity group and the consolidated counterparty group.
- **\$20 million initial margin threshold for affiliates of PR CSEs.** Under the PR rules, a PR CSE may adopt a maximum initial margin threshold amount of \$20 million with each affiliate, below which it need not collect initial margin.

A company is an **affiliate** of another company if:

- either company consolidates the other on its financial statements or both companies are consolidated with a third company under GAAP, IFRS or other similar standards, or would be if any such standards had applied; or
- for the PR rules: a U.S. prudential regulator has determined that a company is an affiliate of another company because the regulator has concluded that either company provides significant support to, or is materially subject to the risks or losses of, the other company.

# Initial and Variation Margin (cont.)

## ADDITIONAL MECHANICS

- **Timing.** Required initial and variation margin must be collected and posted on or before the business day following the day of execution of an uncleared swap<sup>#</sup>, and subsequently at least daily, until the uncleared swap<sup>#</sup> terminates or expires. The definition of “day of execution” provides special treatment for late day and cross-time-zone transactions.
- **Minimum transfer amount.** A covered swap entity is not required to collect or post margin until the amount to be transferred exceeds \$500,000 of combined initial and variation margin.
  - The minimum transfer amount does not change the amount of margin that must be collected once the counterparty crosses the \$500,000 threshold. For example, if the margin amount due from, or to, the counterparty increases from \$400,000 to \$950,000, the covered swap entity must collect the entire \$950,000, subject to the applicable initial margin threshold amount.
- **Minimum requirements.** The final rules establish only *minimum* requirements for initial and variation margin. A covered swap entity may collect or post margin in an amount greater than is required under the final rules.

# Initial and Variation Margin (cont.)

SAFE HARBOR

- A covered swap entity will be deemed **not** to have violated its obligations to collect margin from, or post margin to, a counterparty if the counterparty has refused or failed to provide or accept the required margin and:
  - the covered swap entity has made the necessary efforts to collect or post the required margin; or
  - the covered swap entity has commenced termination of the uncleared swap<sup>#</sup> following the applicable cure period.
- The preambles to the final rules note that it will also not be considered a violation if the counterparty is acting in accordance with agreed practices to settle a dispute.

# Calculating Initial Margin

## OVERVIEW

- The amount of initial margin required to be collected or posted under the final rules (the “Initial Margin Amount”) is determined as follows:

Initial Margin Amount =

An initial margin requirement exists if this number is greater than zero.

Initial Margin  
Collection Amount

minus

Initial Margin  
Threshold Amount

**Non-affiliates:** Maximum threshold of **\$50 million** for uncleared swaps<sup>‡</sup> (other than exempt swaps<sup>‡</sup>) between a consolidated covered swap entity group and a consolidated counterparty group.

**Affiliates of PR CSEs:** Maximum threshold of **\$20 million** for uncleared swaps (other than exempt swaps) between a PR CSE and its affiliate counterparty that is a swap entity or a financial end user with material swaps exposure.

- The minimum Initial Margin Collection Amount may be determined in one of two ways:

using an initial margin model that must be approved by the relevant regulator\* and must conform to the requirements on [slide 11](#);

OR

using a standardized look-up table and formula as shown on [slide 12](#), which allows for limited netting of offsetting exposures.

\* A CFTC CSE may obtain approval from either the CFTC or the NFA.



# Calculating Initial Margin (cont.)

## MODELS

- Initial margin models must be approved by the relevant regulator\* and are subject to ongoing notice to regulators in the event of changes. Models must be subject to robust oversight by the covered swap entity, including at least annual recalibration, validation, maintenance, testing, escalation and documentation.
- Any approved model:
  - must calculate initial margin requirements based on a one-tailed 99% confidence level over a ten-day close-out period (or, for PR CSEs, five days for swaps entered into by PR CSEs with counterparties relying on the CFTC inter-affiliate clearing exemption);
  - may recognize risk offsets within, but not across, the following risk categories:
    - commodity;
    - credit;
    - equity; and
    - FX / interest rate;
  - must capture all of the material risks that affect the uncleared swap‡, including material non-linear price characteristics of the uncleared swap‡; and
  - may not recognize risks, either as offsets or sources of additional risk, from other products that are not subject to the margin requirements to which the covered swap entity is subject.
- Covered swap entities may use a third-party developed model but must receive individual approval by the relevant regulator.

\* A CFTC CSE may obtain approval from either the CFTC or the NFA.

# Calculating Initial Margin (cont.)

## STANDARDIZED APPROACH

$$\frac{\text{Net current replacement cost}}{\text{Gross current replacement cost}}$$

$$\text{Initial Margin Collection Amount} = (0.4 \times \text{Gross Initial Margin}) + (0.6 \times \text{Net-to-Gross Ratio} \times \text{Gross Initial Margin})$$

**Standardized Approach Required Where No Approved Model.** Unless a covered swap entity's initial margin conforms to the initial margin model requirements on [slide 11](#), the covered swap entity must calculate the amount of initial margin required to be collected or posted for uncleared swaps<sup>‡</sup> on a daily basis pursuant to these minimum standards.

**No Cherry Picking.** The regulators noted that a covered swap entity may choose whether to use an approved model or standardized approach, but may not “cherry pick”—regulators would expect the method chosen to be based on fundamental considerations apart from which method produces the most favorable margin results, and covered swap entities may be asked to provide rationale for changing methodologies.

**30% Reduction for Affiliates of PR CSEs.** PR CSEs using this standardized approach for transactions with affiliates may reduce the initial margin amount by 30%.

Notional value x initial margin % below

Asset Class	Gross Initial Margin (% of Notional Exposure)
Credit: 0-2 years	2
Credit: 2-5 years	5
Credit: 5+ years	10
Commodity	15
Equity	15
Foreign Exchange/Currency	6
Cross Currency Swaps: 0-2 years	1
Cross-Currency Swaps: 2-5 years	2
Cross-Currency Swaps: 5+ years	4
Interest Rate: 0-2 years	1
Interest Rate: 2-5 years	2
Interest Rate: 5+ years	4
Other	15

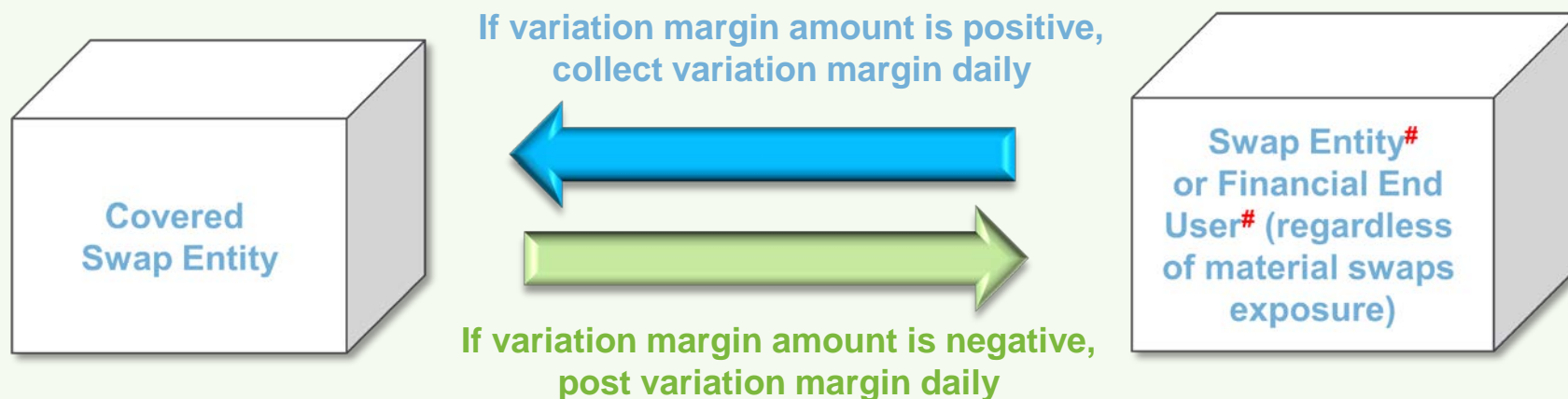
The **Net-to-Gross Ratio** calculation applies only to uncleared swaps<sup>‡</sup> that are subject to the same EMNA.

The **net current replacement cost** = the cost of replacing the entire portfolio of uncleared swaps<sup>‡</sup> covered under a single EMNA.

The **gross current replacement cost** = the cost of replacing those uncleared swaps<sup>‡</sup> that have a strictly positive replacement cost under the EMNA.

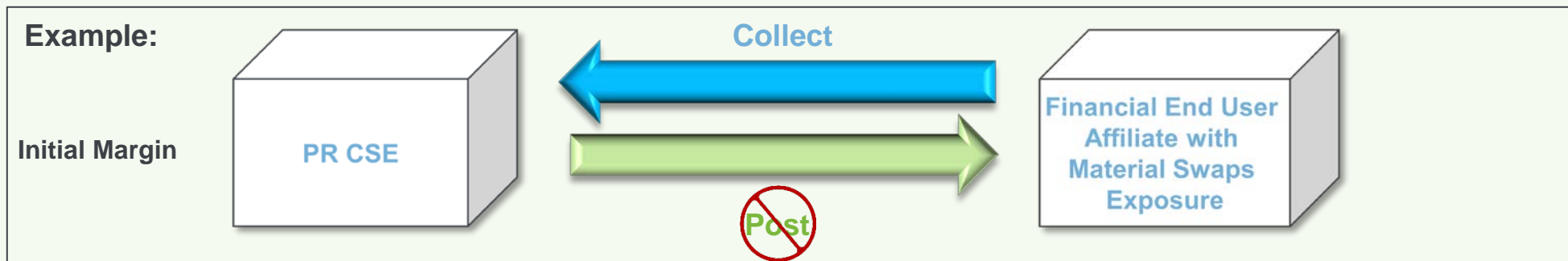
# Calculating Variation Margin

- The variation margin amount is measured in reference to the change in mark-to-market value since the prior exchange of variation margin.

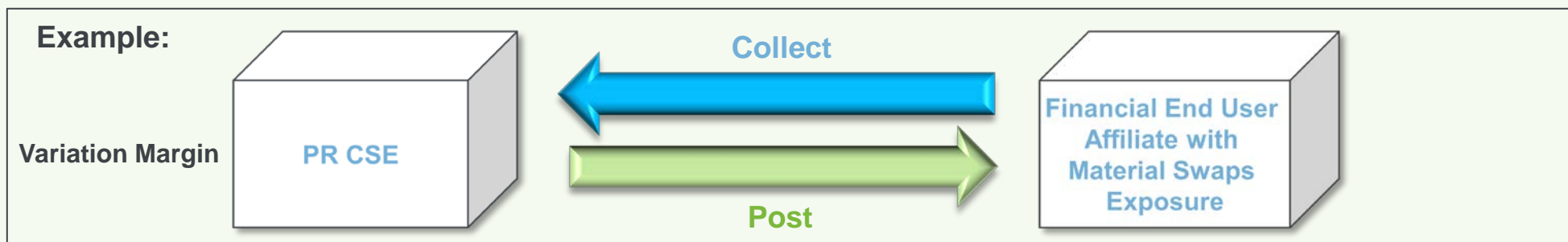


- A covered swap entity is permitted to calculate variation margin requirements on an aggregate net basis across all uncleared swaps<sup>‡</sup> with a counterparty that are executed under a single EMNA or a separate netting portfolio under an EMNA. See [slide 18](#) for further information on netting arrangements.
- Under the CFTC rules, a CFTC CSE must (i) use a methodology and inputs that, to the maximum extent practicable, rely on recently executed transactions, independent third-party valuations and other objective criteria in calculating variation margin and (ii) have fallbacks in place for determining the value of an uncleared swap in the event that another input that is required to value the swap is unavailable.
- No thresholds are permitted for variation margin.

# Special Rules for Inter-Affiliate Swaps of PR CSEs



A PR CSE does not need to post initial margin with an affiliate that is a financial end user with material swaps exposure. However, a PR CSE must calculate the amount of initial margin it would be required to post to its affiliate (but for this exclusion) and to provide that calculation to its affiliate each day. A PR CSE must collect initial margin from the affiliate, subject to a \$20 million maximum threshold.



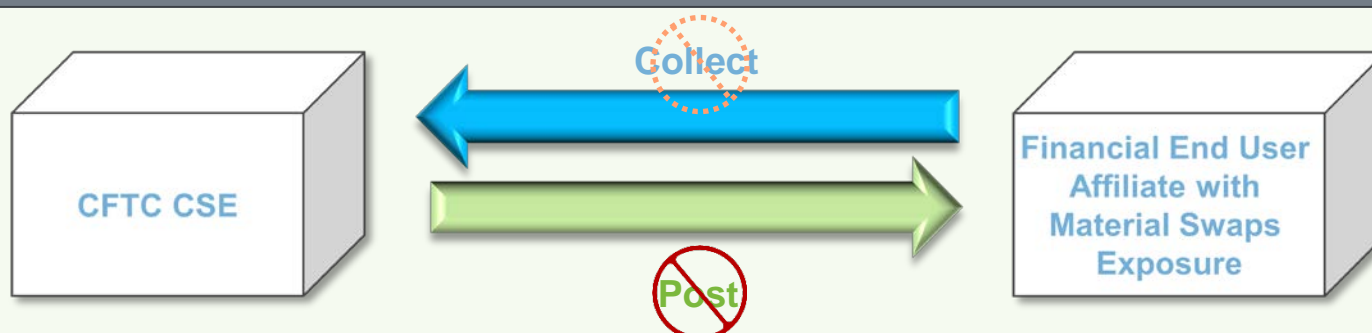
The exclusion described above does **not** apply to variation margin. A PR CSE must collect and post variation margin from its affiliate each day, depending on the classification of the affiliate.

**Special rules also apply to the calculation of initial margin and segregation of collateral for inter-affiliate swaps of PR CSEs.**

# Special Rules for Inter-Affiliate Swaps of CFTC CSEs

**Example:**

**Initial Margin**



A CFTC CSE is not required to post initial margin to an affiliate that is a financial end user with material swaps exposure.

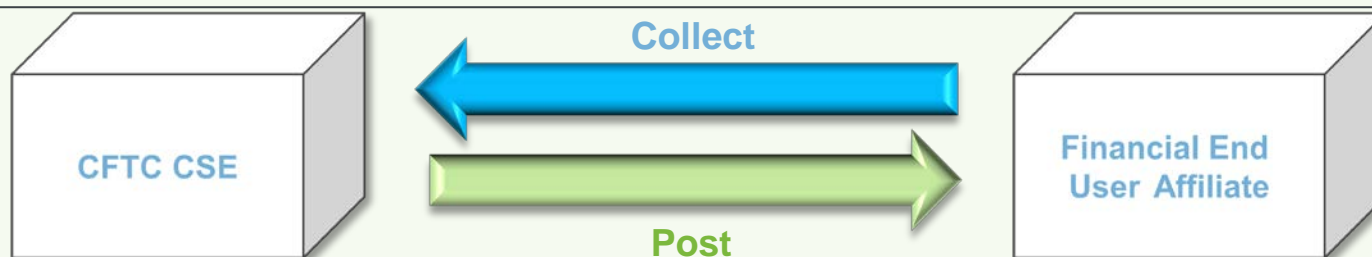
A CFTC CSE must collect initial margin from an affiliate:

- that is a financial end user that enters into uncleared swaps with (1) unaffiliated financial end users or (2) other affiliates that, directly or indirectly, enter into uncleared swaps with unaffiliated financial end users; and
- where the affiliate facing the unaffiliated financial end user is (1) located in a jurisdiction for which substituted compliance for the CFTC rules is not available and (2) does not collect initial margin for its uncleared swaps with unaffiliated financial end users that would satisfy the CFTC rules.

For swaps with other affiliates, a CFTC CSE is not required to collect initial margin from the affiliate, provided that the inter-affiliate swaps are subject to a centralized risk management program.

**Example:**

**Variation Margin**



The exclusion does **not** apply to variation margin. A CFTC CSE must collect and post variation margin from its affiliate each day, depending on the classification of the affiliate.

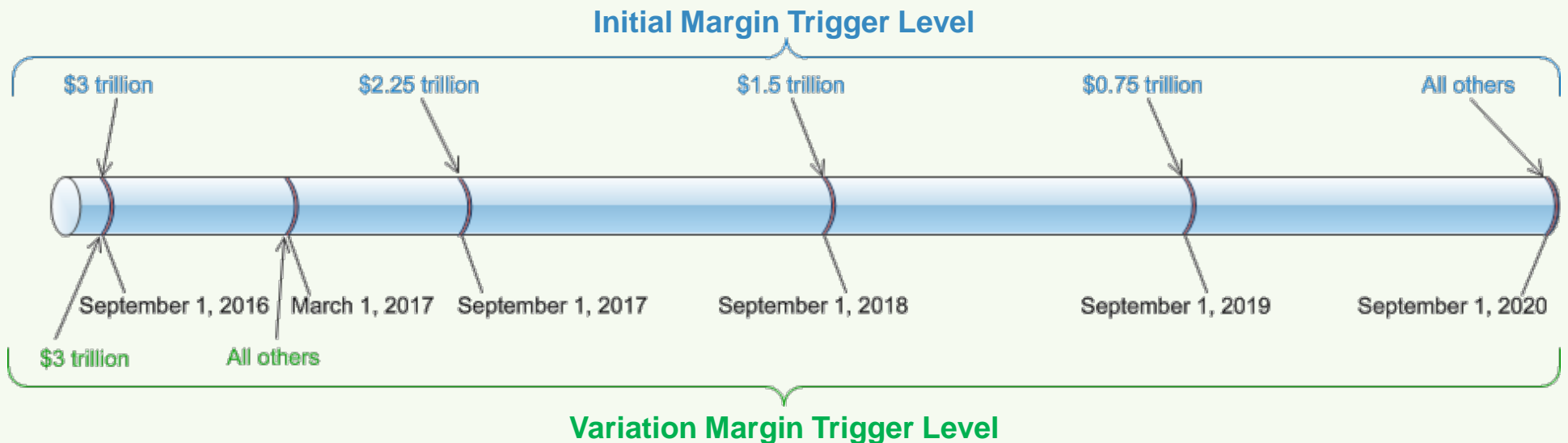
# Exemptions from the Margin Requirements

- Uncleared swaps † between a covered swap entity and the following types of counterparties are exempt from the initial and variation margin requirements, if the uncleared swap † would satisfy the applicable exemption from the clearing requirement:
  - An end user, such as a corporation, a small bank or a captive finance company, that would qualify for an exception from the clearing requirement under section 2(h)(7)(A) of the Commodity Exchange Act or section 3C(g)(1) of the Securities Exchange Act and any implementing regulations;
    - For these purposes, a small bank includes an insured depository institution, a credit union, a savings association or a farm credit system institution with total assets of \$10 billion or less.
  - A cooperative that would qualify for an exemption from clearing under section 4(c)(1) of the Commodity Exchange Act and any implementing rule, regulation or order; and
  - A treasury affiliate that would satisfy the criteria for the exemption from clearing in section 2(h)(7)(D) of the Commodity Exchange Act or section 3C(g)(4) of the Securities Exchange Act and implementing regulations.

# Compliance Timing

## PHASED-IN COMPLIANCE SCHEDULE

- Once the Margin Calculation Amounts, as defined below, for **both** the covered swap entity and its counterparty exceed the relevant Margin Trigger Level, the counterparties must comply with the relevant margin requirement no later than the compliance date specified below for swaps entered into on or after that date.
  - The Margin Calculation Amount for an entity equals the combined average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, FX swaps and FX forwards for each business day in March, April and May, of the entity and its affiliates.
    - Exempt swaps and exempt security-based swaps are not included in the Margin Calculation Amount.
  - Even if either counterparty subsequently falls below the Margin Trigger Level, the pair must continue to comply with the margin requirements.
- Uncleared swaps<sup>‡</sup> entered into before the relevant compliance date can be excluded from the margin requirements if they are restricted to EMNAs or separate netting portfolios within EMNAs that do not include post-compliance date uncleared swaps<sup>‡</sup>. A pre-effective date uncleared swap<sup>‡</sup> that is amended, novated, or assigned after the relevant compliance date may be considered to be a new post-compliance date uncleared swap<sup>‡</sup> for these purposes.



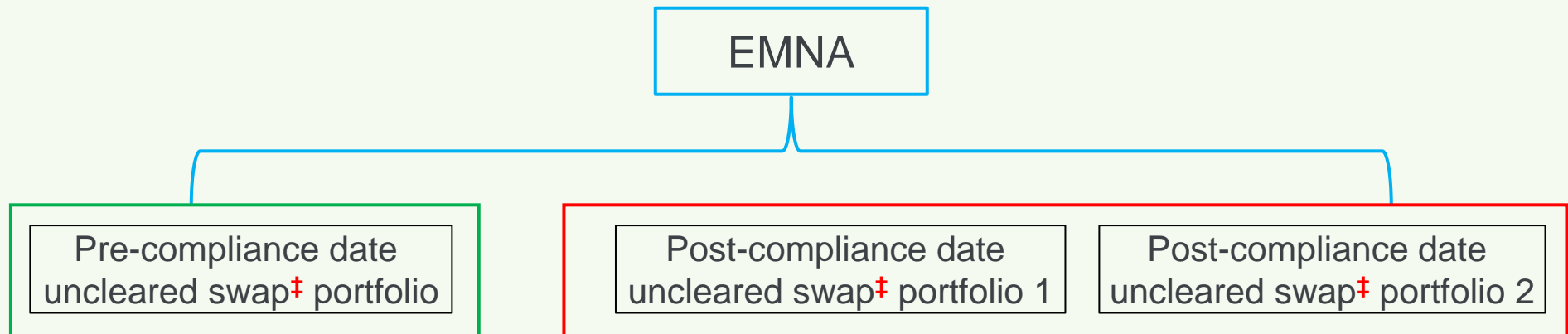
# Netting Arrangements

## ELIGIBLE MASTER NETTING AGREEMENTS

- **Netting.** The final rules permit limited netting for uncleared swaps<sup>‡</sup> under an EMNA but do not permit netting across other products.
  - For example, a PR CSE may net uncleared swaps and uncleared security-based swaps under one EMNA, whereas a CFTC CSE may only net uncleared swaps.
- **Qualifying EMNAs.** Netting agreements must meet specified requirements to qualify as EMNAs. The full list of requirements is available [here](#). Among other things:
  - the agreement must create a single legal obligation for all individual transactions covered by the agreement upon an event of default following certain permitted stays, including upon an event of receivership, conservatorship, insolvency, liquidation or similar proceeding of the counterparty (the “**Close-Out Provision**”);
  - the agreement must provide the covered swap entity the right to accelerate, terminate and close out on a net basis all transactions under the agreement and to liquidate or set off collateral promptly upon an event of default, provided additional circumstances are satisfied;
  - the agreement does not contain a walkaway clause; and
  - the covered swap entity that relies on the agreement to calculate margin must conduct sufficient legal review to conclude with a well-founded basis that (1) the agreement meets applicable requirements and (2) relevant court and administrative authorities would find the agreement to be legal, valid, binding and enforceable under local law.
- **Separate netting portfolios under a single EMNA.** An EMNA may consist of one or more “separate netting portfolios,” defined as a set of transactions that independently meet the Close-Out Provision and to which collecting and posting of margin applies on an aggregate net basis separate from, and exclusive of, any other uncleared swaps<sup>‡</sup> covered by the EMNA.
  - The use of separate netting portfolios permits covered swap entities to ringfence uncleared swaps<sup>‡</sup> subject to different margin posting and collecting requirements.



# Netting Arrangements (cont.)



- **Permitted netting.** A covered swap entity may calculate initial margin (under a model) and variation margin requirements on an aggregate net basis for all uncleared swaps<sup>‡</sup> governed by a single EMNA.
- **Pre-compliance date uncleared swaps<sup>‡</sup>.** The margin requirements do not apply to uncleared swaps<sup>‡</sup> entered into before the relevant compliance date where:
  - the swaps<sup>‡</sup> were entered into under a single EMNA and all swaps<sup>‡</sup> under the EMNA are pre-compliance date swaps<sup>‡</sup>; or
  - the pre-compliance date swaps<sup>‡</sup> entered into under the EMNA are restricted to a separate netting portfolio that does not include post-compliance date swaps<sup>‡</sup>.
- **Non-qualifying master agreements.** A PR CSE trading under a netting agreement that is not an EMNA may apply the agreement's netting provisions for purposes of the posting requirement, but must collect on a gross basis. A CFTC CSE trading under a netting agreement that is not an EMNA must collect and post on a gross basis.

# Eligible Collateral

- **Eligible collateral.** The final rules limit the types of collateral that may be used to satisfy initial and variation margin requirements to high quality, liquid assets. These limitations do not apply to excess margin.

Eligible Collateral	
<b><u>Initial margin:</u></b>	Specified types of cash, securities and gold (see <a href="#">following slide</a> )
<b><u>Variation margin:</u></b>	
Uncleared swap <sup>‡</sup> between covered swap entity and another swap entity <sup>#</sup>	Cash in USD, another “major currency,” or settlement currency of uncleared swap <sup>‡</sup> (see <a href="#">following slide</a> )
Uncleared swap <sup>‡</sup> between covered swap entity and financial end user <sup>#</sup>	Same as initial margin (see <a href="#">following slide</a> )

- **Ineligible collateral.** Securities issued by the following entities are not eligible collateral:
  - the party pledging the collateral or any of its affiliates;
  - a bank holding company, savings and loan holding company, an intermediate holding company, a foreign bank, a depository institution, a market intermediary, or any company that would be one of the foregoing if it were organized under the laws of the United States or any State, or an affiliate of any of these institutions; or
  - a non-bank SIFI.
- **Haircuts.** Specified haircuts apply, as listed on [the following slide](#).
- **Daily monitoring.** A covered swap entity must monitor the market value and eligibility of all collateral collected and posted for required initial and variation margin on a daily basis.

# Eligible Collateral (cont.)

## ELIGIBLE COLLATERAL AND HAIRCUTS

Eligible Collateral	Haircut*
1. Cash in USD or another major currency	0.0
2. Cash in currency of settlement for the uncleared swap†	0.0
3. Eligible government and related debt: residual maturity less than one year**	0.5
4. Eligible government and related debt: residual maturity between one and five years**	2.0
5. Eligible government and related debt: residual maturity greater than five years**	4.0
6. Other eligible publicly traded debt and eligible GSE debt securities not identified in row 3: residual maturity less than one year	1.0
7. Other eligible publicly traded debt and eligible GSE debt securities not identified in row 4: residual maturity between one and five years	4.0
8. Other eligible publicly traded debt and eligible GSE debt securities not identified in row 5: residual maturity greater than five years	8.0
9. Equities included in S&P 500 or related index	15.0
10. Equities included in S&P 1500 Composite or related index but not S&P 500 or related index	25.0
11. Gold	15.0
12. Additional (additive) haircut for collateral denominated in a currency that is not the currency of settlement***	8.0

For uncleared swaps† between swap entities#, only the cash instruments in the first two rows (in green) may be used to satisfy variation margin requirements.

\* Percentage of market value.

\*\* For GSE debt, this includes a security issued by or fully guaranteed as to the payment of principal and interest by, a U.S. government agency (other than the U.S. Department of Treasury) whose obligations are fully guaranteed by the full faith and credit of the U.S. government.

\*\*\* Does not apply to collateral posted for variation margin in cash in the currency of settlement or any major currency, or for collateral posted for initial margin denominated in a single termination currency designated as payable to the non-posting counterparty as part of the EMNA.

# Segregation and Custody

## Segregation

- Collateral **collected by a covered swap entity** to satisfy required uncleared swap<sup>‡</sup> initial margin amounts must be held by one or more custodians unaffiliated with the covered swap entity and the counterparty.
  - Excess initial margin (i.e., collateral exceeding the amount required by the final rules) and variation margin are not required to be segregated.
  - Required initial margin collected by a covered swap entity from its affiliate may be held by the covered swap entity or an affiliate as custodian.
- Any collateral **posted by a covered swap entity** as uncleared swap<sup>‡</sup> initial margin must be held by one or more custodians unaffiliated with the covered swap entity and the counterparty.
  - This requirement also applies to excess initial margin but not to variation margin.

## Custody

- Collateral required to be segregated must be held by the custodian pursuant to an agreement that:
  - prohibits the custodian from rehypothecating, repledging, reusing, or otherwise transferring the collateral it holds;<sup>\*</sup> and
  - is legal, valid, binding, and enforceable under the laws of all relevant jurisdictions, including in the event of bankruptcy, insolvency, or a similar proceeding.
- The agreement may permit the substitution or direct reinvestment of received margin in eligible collateral, subject to restrictions and haircuts.

<sup>\*</sup> Cash collateral may be held in a general deposit account with the custodian if (1) the funds in the account are used to purchase eligible noncash collateral, (2) the eligible noncash collateral is held in compliance with the segregation requirements of the final rules and (3) the purchase of the eligible noncash collateral takes place within a reasonable time after the cash collateral is posted.

# Margin Documentation Requirements

- A covered swap entity must execute trading documentation with each swap entity or financial end user counterparty regarding credit support arrangements, provided that the credit support arrangements:
  - provide the covered swap entity and its counterparty with a contractual right to collect and post initial and variation margin in amounts and in the forms as required by the final rules;
  - specify the methods, procedures, rules and inputs (and for CFTC CSEs, the data sources) for determining the value of each uncleared swap<sup>‡</sup> for calculating variation margin;
  - specify the dispute resolution procedures concerning the valuation of uncleared swaps<sup>‡</sup> or assets collected or posted as initial or variation margin; and
  - describe the methods, procedures, rules and inputs (and for CFTC CSEs, the data sources) used to calculate initial margin for uncleared swaps<sup>‡</sup> entered into between the covered swap entity and its counterparty.
- The trading documentation of each CFTC CSE must comply with swap trading relationship documentation requirements of CFTC Rule section 23.504.

# Extraterritorial Application of the PR Rules

- The PR rules exclude a “foreign non-cleared swap” of a foreign PR CSE from the scope of the margin requirements.\*

## Foreign Non-Cleared Swap

Any uncleared swap or uncleared security-based swap with respect to which neither the counterparty to the foreign PR CSE nor any party that provides a guarantee of either party’s obligations under the uncleared swap or uncleared security-based swap is:

- (1) an entity organized under the laws of the United States or any State (including a U.S. branch, agency, or **subsidiary** of a foreign bank) or a natural person who is a resident of the United States;
- (2) a branch or office of an entity organized under the laws of the United States or any State; or
- (3) a PR CSE that is a subsidiary of an entity that is organized under the laws of the United States or any State.

## Foreign PR CSE

Any PR CSE that is **not**:

- (1) an entity organized under the laws of the United States or any State, including a U.S. branch, agency or subsidiary of a foreign bank;
- (2) a branch or office of an entity organized under the laws of the United States or any State; or
- (3) an entity that is a subsidiary of an entity that is organized under the laws of the United States or any State.

A company is a “**subsidiary**” of another company if:

- the company is consolidated by the other company on financial statements under GAAP, IFRS or other similar standards, or would be if any such standards had applied; or
- a U.S. prudential regulator has determined that a company is a subsidiary of another company because the regulator has concluded that either company provides significant support to, or is materially subject to the risks or losses of, the other company.

\* As of the date of this memorandum, the CFTC has not issued final rules addressing the cross-border application of its margin requirements.

# Extraterritorial Application of the PR Rules (cont.)

## FULL SUBSTITUTED COMPLIANCE

- Full substituted compliance (that is, the ability to collect and post margin in accordance with foreign regulatory requirements) may be available to:

- a foreign PR CSE;
- a U.S. branch or agency of a foreign bank; or
- a subsidiary of a depository institution, Edge corporation or agreement corporation that is not organized under the laws of the United States or any State,

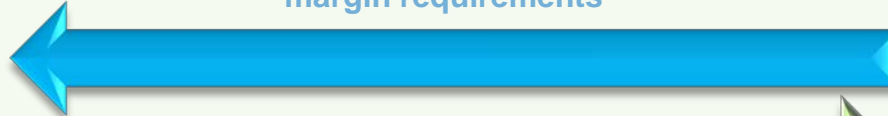
provided that its obligations are not guaranteed by

- an entity organized under the laws of the United States or any State, unless it is a U.S. branch or agency of a foreign bank;
- a natural person who is a resident of the United States; or
- a branch or office of an entity organized under the laws of the United States or any State.

### Example:



Collect pursuant to comparable foreign margin requirements



Post pursuant to comparable foreign margin requirements



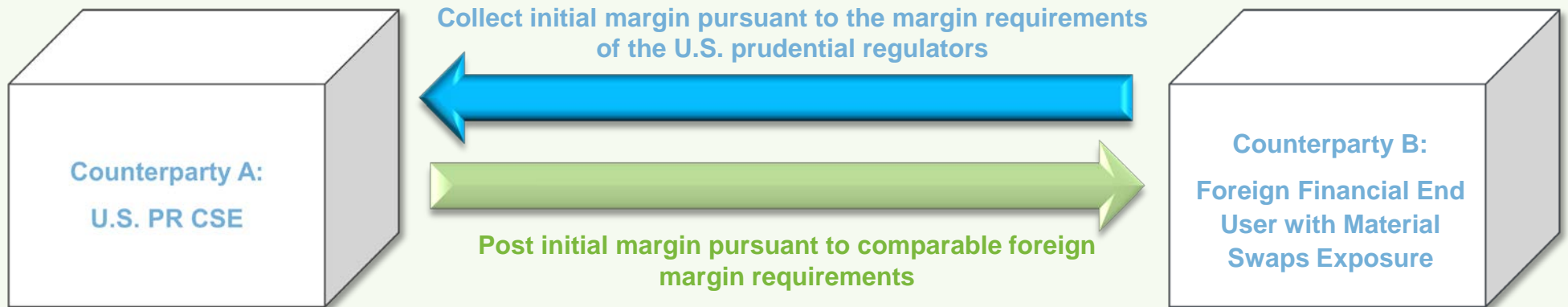
- In order for substituted compliance to be available, the U.S. prudential regulators must jointly make a “comparability” determination in the form of a public order with respect to the relevant foreign regulatory framework.

# Extraterritorial Application of the PR Rules (cont.)

## PARTIAL SUBSTITUTED COMPLIANCE

- Even if full substituted compliance is not available, if the U.S. prudential regulators make a comparability determination for a specific jurisdiction, any PR CSE, including a U.S. PR CSE, may (unless otherwise stated in the determination) satisfy its requirement to **post** (but not collect) initial margin to a financial end user with material swaps exposure by complying with the foreign jurisdiction's regulatory framework for margin collection applicable to the counterparty, provided that:

- the counterparty is required to collect initial margin pursuant to the foreign regulatory framework to which the counterparty is subject; and
- the counterparty's obligations under the uncleared swap or uncleared security-based swap do not have a guarantee from:
  - an entity organized under the laws of the United States or any State;
  - a U.S. branch, agency or subsidiary of a foreign bank;
  - a natural person who is a resident of the United States; or
  - a branch or office of an entity organized under the laws of the United States or any State.



- Subject to a number of conditions, the requirements to post and segregate collateral do not apply to an uncleared swap or uncleared security-based swap entered into by (1) a foreign branch of a PR CSE that is a depository institution or (2) a PR CSE that is a non-U.S. subsidiary of a depository institution, Edge corporation or agreement corporation, if there are certain limitations in the legal or operational infrastructure in the foreign jurisdiction.



# Capital Requirements of the PR Rules

- A PR CSE must comply with the capital requirements already applicable to it.
- No additional PR CSE-specific capital rules are included in the PR rules.
- This may result in significant differences in required capital for swap entities with U.S. prudential regulators and those regulated by the CFTC or the SEC.
  - The CFTC and SEC, however, have not yet finalized the capital rules applicable to the swap entities they regulate.



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