

Derivatives Alert

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CFTC Finalizes Cross-Border Margin Rules for Uncleared Swaps

On May 24, 2016, the Commodity Futures Trading Commission (CFTC) adopted final rules (cross-border margin rules)¹ that specify how its recently issued uncleared margin rules apply to cross-border transactions. Chairman Timothy Massad and Commissioner Sharon Bowen voted in favor of the rules. Commissioner J. Christopher Giancarlo voted against the rules, protesting what he views to be an overly complicated approach: “In effect, the Commission’s approach is somewhat principles-based, except when it is rules-based and somewhat objective, except when it is subjective.”² The rules go into effect 60 days from the date of publication in the Federal Register.

Background

The Dodd-Frank Act required U.S. banking regulators (Prudential Regulators), the CFTC, and the Securities and Exchange Commission (SEC) each to adopt rules requiring swap dealers (SDs) and major swap participants (MSPs) to post margin to and collect margin from certain financial counterparties when entering into swaps that are not centrally cleared.³ At the end of 2015, the Prudential Regulators finalized rules, which included provisions regarding the application of the rules’ margin requirements to cross-border transactions.⁴ The CFTC adopted its uncleared margin rules at the beginning of 2016. The CFTC’s rules apply to non-prudentially regulated SDs and MSPs (covered swap entities or CSEs) and largely resemble the Prudential Regulators’ margin rules in substance.⁵ However, the CFTC’s rules left a placeholder for the application of its margin requirements in a cross-border context, which the cross-border margin rules now address.⁶

¹ The final rules and adopting release (Release) are available [here](#).

² Release at 138.

³ The Prudential Regulators’ margin rules apply to SDs and MSPs that are regulated by one of the Prudential Regulators. The CFTC’s margin rules apply to non-prudentially regulated SDs and MSPs, while the SEC’s margin rules, which have yet to be finalized, will apply to non-prudentially regulated security-based swap dealers and major security-based swap participants. The CFTC currently estimates that of the approximately 106 registered SDs and MSPs, 54 are subject to the CFTC’s rules and the remaining 52 are subject to the Prudential Regulators’ rules. See Release at 10.

⁴ See “Margin and Capital Requirements for Covered Swap Entities,” 80 Fed. Reg. 74916 (Nov. 30, 2015). For more information on the Prudential Regulators’ rules, see Skadden’s November 2, 2015, client alert, available [here](#).

⁵ See “Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants,” 81 Fed. Reg. 636 (January 6, 2016).

⁶ Prior to finalizing its uncleared margin rules, the CFTC separately proposed cross-border margin rules and requested public comment. For more information on the cross-border margin proposal, see Skadden’s July 13, 2015, client alert, available [here](#).

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Definitions

The cross-border margin rules' definitions are central to determining whether and how the CFTC's uncleared margin rules will apply to cross-border transactions. Application depends largely on whether each counterparty to an uncleared swap is a "U.S. person," is controlled by a U.S. person such that the counterparty is consolidated on the U.S. person's financial statements, or is guaranteed by a U.S. person with respect to obligations arising under the uncleared swap.⁷ In general, the U.S. person definition takes a territorial approach by covering persons domiciled or organized in the U.S.⁸ Furthermore, because U.S. person status is determined at the entity level, any foreign operations of a U.S. person legal entity would be included in the U.S. person status. While certain aspects of the U.S. person definition track the definition adopted by the CFTC for purposes of its other swap regulations,⁹ noteworthy distinctions exist. For example, the cross-border margin rules' U.S. person definition does not include funds that are majority-owned by other U.S. persons.¹⁰

The cross-border margin rules identify a subcategory of non-U.S. persons that are CSEs (non-U.S. CSEs) whose uncleared swaps are guaranteed by a U.S. person. These entities — referred to as "U.S. Guaranteed CSEs"¹¹ — are treated as CSEs that are U.S.

⁷ Market participants may reasonably rely upon a counterparty's written status representations unless information is known that would cause a reasonable person to question the accuracy of the representation. See Release at 36.

⁸ For purposes of the cross-border margin rules, "U.S. person" is defined to mean:

- (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 (iv) or (v) of this definition) (a legal entity), in each case that is organized or incorporated under the laws of the United States or that has 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 (iii) of this definition, 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 (i) through (v) of this definition 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 (i) through (vi) of this definition.

⁹ See "Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations," 78 Fed. Reg. 45292 (July 26, 2013).

¹⁰ See Release at 23.

¹¹ The CFTC notes that "a non-U.S. CSE may be considered a U.S. Guaranteed CSE for one swap and not another, depending on whether the non-U.S. CSE's obligations under such swap are guaranteed by a U.S. person." See Release at 25 n.66.

persons (U.S. CSEs) for purposes of the cross-border margin rules due to added systemic risk the CFTC views to exist based on a U.S. person being ultimately liable for any default under the swap. A guarantee is generally defined to mean an arrangement pursuant to which one party to an uncleared swap has rights of recourse against a guarantor with respect to its counterparty's obligations under the uncleared swap, regardless of whether such guarantor is affiliated with the swap counterparty. To address evasion concerns, the CFTC has broadened the guarantee definition to encompass scenarios where the guarantor itself 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.¹²

The cross-border margin rules identify a second subcategory of non-U.S. CSE whose ultimate parent entity is a U.S. person that is required to consolidate the non-U.S. CSE in its financial statements in accordance with U.S. GAAP. These "Foreign Consolidated Subsidiaries" (FCSs) are generally treated as non-U.S. CSEs, although they are not eligible for the outright exclusion under the cross-border margin rules described below. The CFTC views these entities to require greater scrutiny under margin rules than other non-U.S. CSEs (except for U.S. Guaranteed CSEs) because their financial position, operating results and statement of cash flows are included in the financial statements of a U.S. person and therefore affect the financial position, risk profile and market value of that U.S. person.¹³

Application

Depending on the combined status of counterparties to an uncleared swap, the cross-border margin rules provide that the CFTC's margin requirements will apply in full or in part, substituted compliance may be available for some or all requirements,¹⁴ or a complete exclusion from the requirements may be available. The CFTC characterizes its final cross-border margin rules as largely harmonious with the cross-border approach taken by the Prudential Regulators in their margin rules.¹⁵

Generally, the stronger the nexus of a counterparty's status to the U.S. financial system, the less likely substituted compliance or exclusion will be available.¹⁶ For U.S. persons and U.S. Guaranteed CSEs, substituted compliance is only available with

¹² See Release at 28.

¹³ See Release at 33-34.

¹⁴ Substituted compliance refers to the ability to comply with local rules of a non-U.S. jurisdiction in lieu of complying with the CFTC's rules, provided that the CFTC has made a determination that the foreign rules are comparable to the CFTC's rules.

¹⁵ See Release at 37, 41.

¹⁶ See Release at 42.

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respect to posting margin to a non-U.S. person counterparty that is not guaranteed by a U.S. person. Conversely, non-U.S. CSEs (including FCSs) whose obligations under the relevant uncleared swap are not guaranteed by a U.S. person are eligible for substituted compliance for all margin requirements when facing any counterparty other than a U.S. CSE or U.S. Guaranteed CSE.

Complete exclusion from the CFTC's margin rules is available only for uncleared swaps between a non-U.S. CSE and a non-U.S. counterparty (including another non-U.S. CSE), provided that neither counterparty's obligations under the swap are guaranteed by a U.S. person and neither counterparty is an FCS or U.S. branch of a non-U.S. CSE. However, the exclusion is not available if risk from the uncleared swap at issue is transferred through an inter-affiliate trade to a U.S. CSE or a U.S. Guaranteed CSE, and the non U.S. CSE's market-facing uncleared swap with the non-U.S. counterparty is not subject to comparable initial margin requirements in the non U.S. CSE's home jurisdiction.

Please refer to the chart at the end of this alert for an overview of how the CFTC's margin rules will apply to uncleared swaps in a cross-border context.

Special Provisions

The cross-border margin rules provide relief from certain of the CFTC's margin requirements where compliance with such requirements would not be possible due to legal or operational limitations in a non-U.S. jurisdiction. More specifically, when entering into uncleared swaps with non-U.S. persons whose local jurisdiction lacks the legal or operational infrastructure necessary to comply with the CFTC's custodial requirements for margin, an FCS or foreign branch of a U.S. CSE is not required to post initial margin or hold with a third-party custodian any initial margin that is required to be collected, subject to certain

conditions.¹⁷ Additionally, where a CSE cannot conclude with a well-founded basis that a netting agreement with a counterparty in a foreign jurisdiction meets the "eligible master netting agreement" definition in the CFTC's margin rules, the CSE can nonetheless net uncleared swaps in determining the amount of initial margin that it must post, subject to certain conditions.¹⁸

Comparability Determinations

In order for substituted compliance to be available, the CFTC must issue a comparability determination with respect to a specific margin requirement of a foreign jurisdiction. In addition to outlining the process by which a comparability determination should be requested, the cross-border margin rules also outline the approach the CFTC will take in reaching a decision. Notably, the CFTC states that it will take an outcome-based approach to assessing comparability, focusing on whether foreign margin rules are comparable to the CFTC's rules in purpose and effect instead of whether they are identical in approach.¹⁹ The CFTC may determine that some or all of a jurisdiction's margin rules are comparable, which should at least require they be consistent with international standards of the Basel Committee on Banking Supervision and the International Organization of Securities Commissions, although such consistency alone may not be sufficient to finding comparability.²⁰

¹⁷ First, the counterparty can be neither a CSE nor guaranteed by a U.S. person. Second, the CSE must collect initial margin in cash on a gross basis and post and collect variation margin in cash in accordance with the CFTC's margin requirements. Third, for each broad risk category defined under the cross-border margin rules, the total outstanding notional value of all uncleared swaps subject to the non-segregation jurisdiction limitations may not exceed 5 percent of the CSE's total outstanding notional for all uncleared swaps in the same broad risk category. Fourth, the CSE must maintain policies and procedures addressing compliance with these requirements as well as books and records documenting that all conditions are satisfied. See Release at 57-58.

¹⁸ First, 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, but may net those uncleared swaps in determining the amount of initial and variation margin it must post to the counterparty. Additionally, the CSE must maintain policies and procedures addressing compliance with these requirements as well as books and records documenting how these requirements are satisfied. See Release at 61-62.

¹⁹ See Release at 70.

²⁰ See Release at 71.

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CSE	Counterparty	Proposed Approach
U.S. CSE or Non-U.S. CSE (including U.S. branch of a non-U.S. CSE and a Foreign Consolidated Subsidiary (FCS)) whose obligations under the relevant swap are guaranteed by a U.S. person	<ul style="list-style-type: none"> - U.S. person (including U.S. CSE) - Non-U.S. person (including non-U.S. CSE, FCS and U.S. branch of a non-U.S. CSE) whose obligations under the relevant swap are guaranteed by a U.S. person 	U.S. (All)
	<ul style="list-style-type: none"> - Non-U.S. person (including non-U.S. CSE, FCS and U.S. branch of a non-U.S. CSE) whose obligations under the relevant swap are not guaranteed by a U.S. person 	U.S. (Initial Margin collected by CSE in column 1)
		Substituted Compliance (Initial Margin posted by CSE in column 1)
		U.S. (Variation Margin)
FCS whose obligations under the relevant swap are not guaranteed by a U.S. person or U.S. branch of a non-U.S. CSE whose obligations under the relevant swap are not guaranteed by a U.S. person	<ul style="list-style-type: none"> - U.S. CSE - Non-U.S. CSE (including U.S. branch of a non-U.S. CSE and FCS) whose obligations under the relevant swap are guaranteed by a U.S. person 	U.S. (Initial Margin posted by CSE in column 1)
	<ul style="list-style-type: none"> - U.S. person (except as noted above for a CSE) - Non-U.S. person whose obligations under the swap are guaranteed by a U.S. person (except a non-U.S. CSE, U.S. branch of a non-U.S. CSE and FCS whose obligations are guaranteed, as noted above) - Non-U.S. person (including non-U.S. CSE, U.S. branch of a non-U.S. CSE and FCS) whose obligations under the relevant swap are not guaranteed by a U.S. person 	Substituted Compliance (Initial Margin collected by CSE in column 1)
		U.S. (Variation Margin)
		Substituted Compliance (All)
Non-U.S. CSE (that is not an FCS or a U.S. branch of a non-U.S. CSE) whose obligations under the relevant swap are not guaranteed by a U.S. person	<ul style="list-style-type: none"> - U.S. CSE - Non-U.S. CSE (including U.S. branch of a non-U.S. CSE and FCS) whose obligations under the relevant swap are guaranteed by a U.S. person 	U.S. (Initial Margin posted by CSE in column 1)
	<ul style="list-style-type: none"> - U.S. person (except as noted above for a CSE) - Non-U.S. person whose obligations under the swap are guaranteed by a U.S. person (except a non-U.S. CSE whose obligations are guaranteed, as noted above) - U.S. branch of a non-U.S. CSE or FCS, in each case whose obligations under the relevant swap are not guaranteed by a U.S. person 	Substituted Compliance (Initial Margin collected by CSE in column 1)
		U.S. (Variation Margin)
		Substituted Compliance (All)
	<ul style="list-style-type: none"> - Non-U.S. person (including a non-U.S. CSE, but not an FCS or a U.S. branch of a non-U.S. CSE) whose obligations under the relevant swap are not guaranteed by a U.S. person. 	Excluded (except in connection with certain inter-affiliate swaps)