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Alert Memo

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CFTC Proposes Uncleared Swap Margin Requirements

On April 14, 2011, the Commodity Futures Trading Commission ("CFTC") proposed margin requirements under Section 731 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") applicable to certain swap dealers and major swap participants (the "CFTC Proposal").[1] The CFTC Proposal would apply to swap dealers and major swap participants who are not regulated by a "Prudential Regulator" under Dodd-Frank ("CFTC-covered swap entities").[2] The CFTC Proposal is generally comparable to the recently published capital and margin rules proposed by the Prudential Regulators for swap dealers, security-based swap dealers, major swap participants and major security-based swap participants ("swap entities") that are banks or otherwise subject to oversight by the Prudential Regulators ("PR-covered swap entities").[3] There are certain notable differences between the CFTC Proposal and the PR Proposal that we have highlighted below. The SEC has not yet proposed rules regarding capital or margin requirements for security-based swap dealers and major security-based swap participants.

As in the PR Proposal, the CFTC Proposal would generally permit a risk-based approach to initial margin. Unlike the Prudential Regulators' approach, however, the CFTC would not permit CFTC-covered swap entities to use their own proprietary models or a standardized grid to determine initial margin requirements. Instead, the CFTC Proposal would permit a CFTC-covered swap entity to determine initial margin requirements using a

[1] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants (April 14, 2011), available at http://cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister041211.pdf. The CFTC did not propose capital rules for covered swap entities, although it did indicate that it will propose these at a later date and align the comment periods of the margin and capital proposals.

[2] Under Dodd-Frank, the "Prudential Regulators" are the Federal Reserve Board ("FRB"), the Federal Deposit Insurance Corporation ("FDIC"), the Federal Housing Finance Agency ("FHFA"), the Farm Credit Administration ("FCA") and the Office of the Comptroller of the Currency ("OCC"). The Prudential Regulators published proposed rules regarding the Margin and Capital Requirements for Covered Swap Entities (Apr. 12, 2011), available at http://fdic.gov/news/board/Apr11no4.pdf (the "PR Proposal"). For further information about the PR Proposal, please see the CGSH Alert Memo "Prudential Regulators Propose Swap Margin and Capital Requirements" available at http://www.cgsh.com/prudential_regulators_propose_swap_margin_and_capital_requirements/ (the "CGSH PR Alert Memo") and the attached chart.

[3] Specifically, swap entities having a Prudential Regulator include: (a) in the case of the FRB, any state member bank, bank holding company, savings and loan holding company, foreign banking organization, state branch or state agency of a foreign bank, or Edge or agreement corporation; (b) in the case of the FDIC, any FDIC-insured state-chartered bank that is not a member of the Federal Reserve System or FDIC-insured state-chartered savings association; (c) in the case of FHFA, Fannie Mae, Freddie Mac, or any Federal Home Loan Bank; (d) in the case of the FCA, any institution chartered under the Farm Credit Act of 1971; or (e) in the case of the OCC, any national bank, Federal savings association, or Federal branch or agency of a foreign bank.

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risk-based model currently used by a derivatives clearing organization ("DCO"), an entity subject to regular assessment by a Prudential Regulator, or a vendor, subject to certain baseline parameters and approval by the CFTC. As a result, for example, a CFTC-covered swap entity that is part of a bank holding company would be permitted to use the proprietary margin model of an affiliated entity if that entity is "subject to regular assessment" by a Prudential Regulator.[4]

As in the case of the PR Proposal, the CFTC would require the use of a minimum 99% confidence interval and a 10-day measurement horizon in computing potential future exposure. However, under the CFTC proposal, a CFTC-covered swap entity could also require twice the amount of initial margin required by a DCO to clear a "comparable" swap in the same asset class as the uncleared swap. If there is no comparable cleared swap, the CFTC-covered swap entity could require 4.4 times the amount required to clear a futures contract in the same asset class that most closely approximates the uncleared swap and would most likely be used to hedge the uncleared swap. Under this alternative method, portfolio-based reductions in the margin requirement would be allowed within asset classes (where there is a "sound theoretical basis and significant empirical support" for the offsetting risk characteristics of the underlying products) and, in the case of currency and interest rate swaps only, across classes to a maximum reduction of 50% of the amount of margin otherwise required.

As in the PR Proposal, the CFTC Proposal would distinguish among swap counterparties. Under the CFTC Proposal, counterparties would be categorized as swap entities, financial entities, and nonfinancial entities to determine the maximum permitted threshold for unmargined exposure as well as the required frequency of mark-to-market margin calls. Pension plans, foreign sovereigns and foreign central banks, among others, would all be considered financial entities. Even though, unlike the PR Proposal, the CFTC does not distinguish between "high risk" and "low risk" financial entities, the CFTC Proposal would permit non-zero margin thresholds for financial entities that meet certain requirements (e.g., the financial entity does not have significant swaps exposure). This would create a similar distinction in practice to that arising under the PR Proposal.

Significantly, as in the PR Proposal, the CFTC would require that initial margin provided by a CFTC-covered swap entity to another swap entity would be required to be segregated by the receiving swap entity with an independent third party custodian. As a result, under both Proposals, margin and associated segregation requirements would significantly increase the funding required to collateralize the OTC swap market, raising the cost of using uncleared swaps to manage risk.

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[4] The CFTC Proposal does not provide further interpretative gross on the meaning of the phrase "subject to regular assessment," or otherwise directly address the use of proprietary margin models that have been approved by a foreign bank's home country regulator or by the SEC, so it is not entirely clear whether, or under what circumstances, those models would be permitted to be used by a CFTC-covered swap entity.

The CFTC Proposal would diverge from the CFTC's earlier proposal related to the protection of the collateral of counterparties to uncleared swaps.[5] Under that earlier proposal, the CFTC did not require that the custodian for segregated initial margin be unaffiliated with the CFTC-covered swap entity. Moreover, under that proposal, the CFTC would only have required that there be a written custody agreement between a swap dealer/major swap participant and the custodian, not a tri-party agreement. In contrast, the CFTC Proposal would require swap entities to offer to counterparties the opportunity to select custodians unaffiliated with the CFTC-covered swap entity and would, for swaps between CFTC-covered swap entities and other swap entities or financial entities, require the parties to enter into tri-party custodial agreements.

In contrast to the PR Proposal, the CFTC Proposal would prohibit a CFTC-covered swap entity from posting initial margin received from a counterparty as margin for other transactions, including initial (non-swap entity) margin that is not required to be segregated. This prohibition would prevent the CFTC-covered swap entity from margining offsetting or hedging transactions using assets received as initial margin. The proposed limitation on rehypothecation of initial margin as margin for hedging purposes seems inconsistent with Dodd-Frank's limitation of the segregation requirements to circumstances in which a counterparty has requested such segregation. It is also unclear what such a limitation would mean or require in practice once counterparty collateral is permissibly commingled with property of the swap entity.

Neither the CFTC Proposal nor the PR Proposal includes exceptions for transactions by a swap entity with an affiliate or a special purpose vehicle ("SPV"). The absence of these exceptions could pose problems in the case of inter-affiliate risk management arrangements involving swaps and certain securitization or other structures involving SPV issuers.[6]

Unlike the PR Proposal, the CFTC Proposal does not provide guidance with respect to the extra-territorial or cross-border application of its proposed rules.[7] The CFTC has indicated informally, however, that it is considering some extraterritorial and cross-border

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[5] See Notice of Proposed Rulemaking, Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy, 75 F.R. 75432 (Dec. 3, 2010).

[6] Rating agencies typically require that the swap counterparty to an SPV rely on a senior security interest in the SPV's assets (rather than an actual transfer of cash or other collateral) and that the swap counterparty's senior right of payment be subordinated if the swap counterparty causes an early termination of the swap.

[7] Under the PR Proposal, the proposed margin collection requirements would generally apply to swaps entered into opposite a covered swap entity, but would not apply where a "foreign covered swap entity" deals with certain non-U.S. domiciled counterparties. However, branches or offices of U.S. persons and entities controlled by U.S. persons would not qualify as "foreign covered swap entities." As discussed in greater detail in the CGSH PR Alert Memo, this expansion of the territorial scope of the PR Proposal could give rise to significant competitive disparities between U.S. and foreign-headquartered institutions in the event that U.S. margin requirements are significantly more stringent than the requirements adopted in non-U.S. jurisdictions.

application of U.S. margin requirements. The CFTC also has specifically requested comment as to when swap dealing activity with or by non-U.S. affiliates of U.S. persons might trigger U.S. jurisdiction and the appropriate measures to determine the degree of risk that a putative major swap participant's activities pose to the U.S. market.[8]

The CFTC Proposal would generally apply to transactions entered into after the effective date of the final margin regulation. Unlike the Prudential Regulators, the CFTC has not indicated when, after finalization, the margin rules would come into effect.[9] The CFTC has, however, requested comment on whether CFTC-covered swap entities would be permitted voluntarily to include pre-effective date swaps in portfolios margined pursuant to the CFTC Proposal.

The table below provides a comparison of the two Proposals with commentary on certain key features and differences between, the Proposals.

8 See Notice of Proposed Rulemaking, Registration of Swap Dealers and Major Swap Participants, 75 F.R. 71379 (Nov. 23, 2010).

9 Under the PR Proposal, the final margin rules would become effective 6 months after publication.

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	Regulatory Proposal		
Regulatory Requirement	**PR Proposal**	**CFTC Proposal**	**Observations and Comments**
Determination of initial margin	A PR-covered swap entity could calculate the amount of initial margin based on either: (i) an internal margin model that meets certain criteria (discussed further below) and has been approved by the relevant Prudential Regulator; or (ii) a standardized table specifying, by asset category and term, an initial margin amount equal to a percentage of swap notional.	CFTC-covered swap entities may calculate initial margin in one of two ways: (i) a risk-based model currently used or offered by a DCO, an entity subject to regular assessment by a Prudential Regulator, or a vendor, and, in each case, approved by the CFTC; or (ii) using a specified multiple of the initial margin required by a DCO for a "comparable" cleared swaps or futures.	Generally speaking, market participants have taken a model-based approach to calculating margin. The calibration of such models that would be required under each proposal will result in significantly higher margin requirements than under current risk models.
Use of models to determine initial margin	Approved internal risk management models would be permitted to calculate initial margin.	Models used to calculate initial margin must either be: (1) currently used by a DCO for margining cleared swaps; (2) currently used by an entity subject to regular assessment by a prudential regulator; or (3) made available by a vendor. The CFTC must approve all models.	The CFTC's Proposal would not permit the use of a CFTC-covered swap entity's own proprietary models to determine initial margin. A CFTC-covered swap entity that is part of a bank holding company would be permitted to use the proprietary margin model of an affiliated entity if that model is subject to regular assessment by the affiliate's Prudential Regulator.

	Regulatory Proposal		
Regulatory Requirement	**PR Proposal**	**CFTC Proposal**	**Observations and Comments**
			The CFTC Proposal does not directly address the use of proprietary margin models that have been approved by a foreign bank's home country regulator or by the SEC, and so it is not entirely clear whether, or under what circumstances, those models would be permitted to be used by a CFTC-covered swap entity. The CFTC has left open the possibility that it will issue a written order permitting CFTC-covered swap entities to apply to use their own proprietary models.
• Model Calibrations	The model must be based on a measure of potential future exposure using a one-tailed 99% confidence interval and a 10-day time horizon and assuming an instantaneous price shock to all relevant risk factors.	The model must cover at least 99% of price changes by product and by portfolio over at least a 10-day liquidation time horizon.	The proposed 10-day time horizon in both the PR and CFTC Proposals is substantially longer than the 3- to 5-day time horizon typical of clearinghouse margin models.[10] This difference is intended to offset the lower liquidity of non-cleared swaps and to encourage the use of cleared swaps.

[10] Covered swap entities would also be required to periodically benchmark their initial margin models against observable margin standards to ensure that the initial margin required is not less than the level a clearinghouse would require for similar transactions. The Prudential Regulators request comment regarding whether such benchmarking would adequately capture portfolio effects or address transactions not similar to cleared swaps.

	Regulatory Proposal		
Regulatory Requirement	**PR Proposal**	**CFTC Proposal**	**Observations and Comments**
• Minimum Data Sample/Stress Test	The model must use at least one year of historic price data and incorporate a stress test component to ensure the adequacy of the required initial margin level during a period of financial stress in which the risk of counterparty default is heightened.	The model must use at least one year of historic price data, and must include an appropriate "period of significant financial stress."	The Prudential Regulators and CFTC request comment regarding whether a longer historical data sample requirement would be a better alternative to requiring the inclusion of a period of financial stress.
• Netting and Portfolio Offsets	Offsets within four broad risk categories (commodity, credit, equity, foreign exchange/interest rates), but not across those categories, may be used to calculate initial margin. Portfolio effects arising from swap and non-swap positions, however, would not be permitted to be taken into account.	The CFTC Proposal would permit portfolio offsets or reductions with a sound theoretical basis and significant empirical support. The Commission further requests comment on whether offsetting exposures, diversification and other hedging benefits should be recognized, as well as whether limits should be placed on such recognition.	It does not appear that either Proposal would allow the netting of non-swap positions with swap positions.

	Regulatory Proposal		
Regulatory Requirement	**PR Proposal**	**CFTC Proposal**	**Observations and Comments**
• Qualifying Master Netting Agreement	Only rights and obligations arising under swaps subject to the same "qualifying master netting agreement" would be permitted to be offset. "Qualifying master netting agreement" would be defined to require, among other provisions, that the PR-covered swap entity have 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, and that the exercise of such rights in a bankruptcy, insolvency or similar proceeding of the counterparty not be stayed or avoided under applicable law.	The CFTC has not required a concept of "qualifying master netting agreement" because of other regulatory requirements it has proposed for swap documentation, but has requested comment on this point.	The PR Proposal's "qualifying master netting agreement" definition would, likely unintentionally, disqualify any netting agreement with a U.S. bank, broker-dealer or other entity subject to a stay of close-out or foreclosure rights under the applicable U.S. insolvency regime (such as an entity subject to orderly liquidation under Title II of Dodd-Frank or to government-sponsored enterprise conservatorship provisions). The CFTC's swap trading relationship documentation requirements do not appear to have a similar effect.

	Regulatory Proposal		
Regulatory Requirement	**PR Proposal**	**CFTC Proposal**	**Observations and Comments**
Determining initial margin without the use of models	PR-covered swap entities would be permitted to collect initial margin equal to a percentage of swap notional that would vary according to the underlying asset category and swap term.[11]	A CFTC-covered swap entity could determine the initial margin requirement at twice the amount of initial margin required by a DCO to clear a "comparable" swap in the same asset class as the uncleared swap. If there is no comparable cleared swap, the CFTC-covered swap entity could alternatively require 4.4 times the amount required to clear a futures contract in the same asset class that most closely approximates the uncleared swap and would most likely be used to hedge the uncleared swap.	The CFTC's approach may reflect commercial reality more closely by permitting portfolio-based reductions, even though portfolio effects arising from swap and non-swap positions would not be taken into account.
• Netting and Portfolio Offsets	Netting and portfolio effects would not be recognized. The aggregate minimum initial margin amount would be determined by summing the minimum initial margin requirement for each individual swap.[12]	Portfolio-based reductions would be allowed within asset classes if there is a sound theoretical basis and significant empirical support of the offsetting risk characteristics of the underlying products.	The limited recognition of netting and portfolio effects would potentially significantly increase counterparty collateral requirements.

[11] Asset categories would include credit swaps with 0-2 year duration (1-3% of notional), credit swaps with 2-5 year duration (2-8% of notional), credit swaps with 5+ years duration (5-15% of notional), commodity swaps (10-20% of notional), equity swaps (10-20% of notional), foreign exchange/currency swaps (3-9% of notional), interest rate swaps with 0-2 year duration (0-2% notional), interest rate swaps with 2-5 year duration (1-3% of notional), interest rate swaps with 5+ year duration (2-6% of notional) and other swaps (10-20% of notional).

[12] The Prudential Regulators request comment on methods for recognizing hedging effects, such as separately calculating initial margin for long versus short positions and using only the higher amount or adjusting gross notional positions in particular risk categories by a net-to-gross ratio or a netting factor.

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	Regulatory Proposal		
Regulatory Requirement	**PR Proposal**	**CFTC Proposal**	**Observations and Comments**
		Such reductions would not be permitted across asset classes, other than as between interest rate and currency swaps. Any reduction could not exceed 50%. Portfolio effects arising from swap and non-swap positions, however, would not be permitted to be taken into account.	
Timing of Collection of Initial Margin	Initial margin would be required to be collected on or before the date that the PR-covered swap entity enters into the swap.	Initial margin would be required to be collected on or before the date that the CFTC-covered swap entity executes the swap, and such margin must be maintained until the swap is liquidated.	It is not clear whether the complexity of firms' models for computing potential credit exposure will create challenges for the real-time, swap-by-swap or individual counterparty swap portfolio computation of margin.
Types of swap counterparties	Four different categories of counterparties to PR-covered swap entities are considered: (1) other swap entities, (2) nonfinancial end users, (3) high-risk financial end users (including pension plans and foreign sovereign entities), and (4) low-risk financial end users.	Three different categories of counterparties to CFTC-covered swap entities are considered: (1) other swap entities, (2) financial entities (including pension plans and foreign sovereign entities) and (3) nonfinancial entities.	Although the CFTC does not explicitly distinguish between 'high risk" and "low risk" financial entities, its proposed rules permitting non-zero margin thresholds for financial entities that meet certain requirements (e.g., the financial entity does not have significant swaps exposure) create a similar distinction in practice, as discussed below.

	Regulatory Proposal		
Regulatory Requirement	**PR Proposal**	**CFTC Proposal**	**Observations and Comments**
Transactions with other swap entities	PR-covered swap entities would be required to collect initial and variation margin from other swap entities, subject to a $100,000 minimum transfer threshold. A margin threshold of zero would apply to such swaps.	CFTC-covered swap entities would be required to collect initial and variation margin from other swap entities, subject to a $100,000 minimum transfer threshold. A margin threshold of zero would apply to such swaps.	
• Initial Margin	Initial margin would be required to be held by an independent third-party custodian for swaps between a PR-covered swap entity and another swap entity.	Initial margin would be required to be held by an independent third-party custodian for swaps between a CFTC-covered swap entity and another swap entity.	The Prudential Regulators acknowledge that the proposed segregation requirement will impose a significant drain on liquidity but nevertheless argue that segregation is justified on a safety and soundness basis, noting that rehypothecation of initial margin could prevent recovery of margin by a non-defaulting party when one of the swap entities defaults, reduce the net amount of margin required to be posted and encourage swap entities to engage in non-cleared swaps to avoid the limits on rehypothecation resulting from posting margin to a clearinghouse.
• Variation Margin	Variation margin would be required to be collected daily.	Variation margin would be required to be collected daily.	
• Segregation of Variation Margin	No segregation of variation margin would be required.	No segregation of variation margin would be required.	

	Regulatory Proposal		
Regulatory Requirement	**PR Proposal**	**CFTC Proposal**	**Observations and Comments**
Transactions with financial end users / financial entities[13]	PR-covered swap entities would be required to collect initial and variation margin from (but not required to post margin to) counterparties that are financial end users.	CFTC-covered swap entities would be required to collect initial and variation margin from (but not required to post margin to) financial entities.	The CFTC has requested extensive comment on the collection of margin, including as to whether the requirements of one-way variation margin are consistent with Dodd-Frank's goals. Specifically, the CFTC is concerned that not requiring two-way variation margin could lead CFTC-covered swap entities to accumulate large current exposures.
• Margin requirements for "high risk" financial end users	If the counterparty is a "high risk" financial end user, the collection of initial margin would be required, subject to a $100,000 minimum transfer threshold. In this case, a margin threshold of zero will apply.	If the financial entity does not meet a three part test (discussed further below), the collection of initial and variation margin would be required, subject to a $100,000 minimum transfer threshold. In this case, a margin threshold of zero will apply. The parties may agree to a threshold below which the CFTC-covered swap entity is not required to post margin.	

13 Under the PR and CFTC Proposals, a non-swap entity counterparty is a "financial end user" or "financial entity" (as defined in each Proposal, respectively) if it is: (1) a commodity pool, a private fund, an employee benefit plan or governmental plan; (2) a person predominantly engaged in activities that are in the business of banking or in activities that are "financial in nature"; (3) a person that would otherwise be a commodity pool or private fund if it were organized under U.S. law; or (4) a government of any foreign country or a political subdivision, agency or instrumentality thereof. Under both Proposals, regulators would have discretion to designate other persons as financial end users. These definitions are substantially broader than the "financial entity" definition used for purposes of Dodd-Frank's end user clearing exception. For example, these definitions capture foreign commodity pools, foreign private funds and, notably, foreign sovereigns.

	Regulatory Proposal		
Regulatory Requirement	**PR Proposal**	**CFTC Proposal**	**Observations and Comments**
• "Low risk" financial end users	Financial end users would be considered "low risk" and have a non-zero margin threshold if they:	The CFTC does not explicitly divide financial entities into "high risk" and "low risk" categories, but allows non-zero margin thresholds for financial entities that:	
	(1) do not have significant swap exposure (a level designed to equal half the level of uncollateralized outward exposure that would require registration as a major swap or security-based swap participant under the substantial counterparty exposure prong of the proposed major swap and security-based swap participant definitions),[14]	(1) do not have significant swap exposure (a level designed to equal half the level of uncollateralized outward exposure that would require registration as a major swap participant under the substantial counterparty exposure prong of the CFTC's and SEC's proposed major swap participant definition),[15]	Under the PR Proposal, a financial end user would qualify for a non-zero margin threshold only if both its swap and security-based swap positions did not exceed the relevant threshold. Under the CFTC Proposal, a financial entity would qualify so long as its swap positions did not exceed the threshold.

[14] For swaps, this threshold would equal $2.5 billion in daily average aggregate uncollateralized outward exposure or $4 billion in daily average aggregate uncollateralized exposure plus daily average aggregate potential outward exposure. For security-based swaps, it would equal $1 billion in daily average aggregate uncollateralized outward exposure or $2 billion in daily average aggregate uncollateralized exposure plus daily average aggregate potential outward exposure. See Joint Proposed Rules Further Defining the Terms "Swap Dealer," "Security Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant", 75 Fed. Reg. 80174 (Dec. 7, 2010).

[15] Like the Prudential Regulators, the CFTC proposes to set this threshold at $2.5 billion in daily average aggregate uncollateralized outward exposure or $4 billion in daily average aggregate uncollateralized exposure plus daily average aggregate potential outward exposure.

	Regulatory Proposal		
Regulatory Requirement	**PR Proposal**	**CFTC Proposal**	**Observations and Comments**
	(2) predominantly use swaps to hedge or mitigate the risks of its business activities, including balance sheet or interest rate risk, <u>and</u>	(2) predominantly use uncleared swaps to hedge or mitigate the risks of its business activities, including balance sheet or business or interest rate risk, <u>and</u>	This second prong indicates a difference in scope: under the PR Proposal, a financial entity is required to look at both its cleared and uncleared swap activities to satisfy this test; under the CFTC Proposal, however, only uncleared swaps must meet the predominance standard.
	(3) are subject to capital requirements established by a Prudential Regulator or state insurance regulator.	(3) are subject to capital requirements established by a Prudential Regulator or state insurance regulator.	As a result of prong (3) of both tests, funds and other collective investment vehicles (notably including pension plans), U.S. and foreign broker-dealers and futures commission merchants, foreign banks without U.S. banking operations and foreign sovereign entities and their instrumentalities would necessarily be unable to benefit from higher thresholds under which margin would not be required to be collected.

	Regulatory Proposal		
Regulatory Requirement	**PR Proposal**	**CFTC Proposal**	**Observations and Comments**
• Margin requirements for low risk financial end users	If a financial end user counterparty qualifies as a "low risk" counterparty, rather than a "high risk" counterparty, a PR-covered swap entity would be required to collect initial or variation margin only at the point at which the initial and variation margin requirements exceed the lesser of (i) $[15 to 45] million and (ii) [0.1 to 0.3]% of the swap entity's regulatory capital,[16] subject to a minimum transfer threshold of $100,000.	For an entity that meets the 3-prong test, the maximum (initial and variation margin) threshold would be the lesser of $[15 to 45] million and [0.1 to 0.3]% of the regulatory capital of the CFTC-covered swap entity. No minimum transfer threshold would apply to such margin requirements.	As a result of the higher thresholds for variation margin applicable to "low risk financial end users" under the PR Proposal, many community banks and smaller regional banks whose swap activities qualify them as low risk financial end users and whose swap activities are sufficiently limited in scope may not be required to post margin.
• Segregation of Initial Margin	No individual customer segregation of initial margin would be required, but end user counterparties may request such segregation.	No individual customer segregation of initial margin would be required, but end user counterparties may request such segregation.	
• Segregation of Variation Margin	No segregation of variation margin would be required.	No segregation of variation margin would be required.	
• Frequency of Margin Collection	Variation margin would be required to be collected daily from both "high risk" and "low risk" financial end users.	Variation margin would be required to be collected on a daily basis from a financial entity.	

[16] For OCC, FDIC, and FRB regulated swap entities, this regulatory capital would be Tier 1 capital. For FHFA-regulated swap entities, this measurement would be based on total capital and, for FCA-regulated swap entities, on either core surplus or core capital, as applicable. The Prudential Regulators have preliminarily suggested that they believe that a threshold in the middle of the proposed ranges would be appropriate.

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	Regulatory Proposal		
Regulatory Requirement	**PR Proposal**	**CFTC Proposal**	**Observations and Comments**
Transactions with nonfinancial end-users or nonfinancial entities	For nonfinancial end users,[17] PR-covered swap entities would be required to establish internal credit limits at levels consistent with the PR-covered swap entity's internal credit risk management policies and parameters. A PR-covered swap entity would be required to collect initial and variation margin from nonfinancial end users only if the amount that the swap entity would otherwise collect exceeds the credit exposure threshold so established by the PR-covered swap entity (and exceeds the $100,000 minimum transfer threshold noted above).	Nonfinancial entity counterparties and CFTC-covered swap entities may specify thresholds below which they would not be required to pay initial or variation margin to each other.	Consistent with the overall framework, swap entities would not be required to post margin to financial and nonfinancial end users/entities, as had been suggested by some legislative colloquies and letters. CFTC-covered swap entities would nevertheless be required to have margin documentation in place with nonfinancial entities. These documents must contain initial and variation margin requirements and identify the forms of eligible assets, as well as associated valuation haircuts.[18] The CFTC requests comment as to whether one-way margin obligations could have a negative impact on risk management by CFTC-covered swap entities.
• Segregation of Initial Margin	No segregation of initial margin would be required, but nonfinancial end user counterparties may request such segregation.	No segregation of initial margin would be required, but nonfinancial entity counterparties may request such segregation.	

[17] Nonfinancial end users would include any counterparty that is neither a swap entity nor a financial end user.

[18] See Notice of Proposed Rulemaking, "Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants," 76 F.R. 6715 (Feb. 8, 2011).

	Regulatory Proposal		
Regulatory Requirement	**PR Proposal**	**CFTC Proposal**	**Observations and Comments**
• Segregation of Variation Margin • Frequency of Margin Collection	No segregation of variation margin would be required. Variation margin (subject to the $100,000 minimum transfer threshold) would be required to be collected from nonfinancial end users on a weekly (as opposed to daily) basis.	No segregation of variation margin would be required. Variation margin would be required to be collected from a nonfinancial entity according to the terms of any credit support arrangement.	
Covered transactions	Swaps and security-based swaps entered into on or after 180 days following the publication of the final rule in the Federal Register. The proposed margin requirements would not apply to swaps outstanding as of the effective date of the final rule. PR-covered swap entities would, if they so elect, be permitted to compute counterparty margin requirements on a portfolio basis including pre-effective date swaps or restricting the portfolio to post-effective date swaps.	Swaps executed on or after the (not yet specified) effective date of the final regulation.	Unlike the Prudential Regulators, the CFTC does not provide guidance as to the length of the contemplated transition period. The CFTC has requested comment as to whether CFTC-covered swap entities should be permitted to voluntarily include pre-effective date swaps in their portfolios to be margined according to the CFTC Proposal.[19]

[19] Note that the CFTC Proposal would permit the aggregation of variation margin requirements arising from agreements under a unique swap trading relationship document, so long as all agreements under the documentation (including those entered into before the effective date of the regulations) are included.

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	Regulatory Proposal		
Regulatory Requirement	**PR Proposal**	**CFTC Proposal**	**Observations and Comments**
Safe harbor from violations of obligation to collect	A PR-covered swap entity would not violate its obligation to collect margin if its counterparty has failed to provide the required variation margin and the PR-covered swap entity has either made necessary and timely efforts to attempt to collect the margin or commenced termination of the swap.	A CFTC-covered swap entity would not violate its obligation to collect margin if its counterparty has failed to provide the required variation margin and the CFTC-covered swap entity has either made necessary and timely efforts to attempt to collect the margin or commenced termination of the swap.	Neither Proposal sets forth a specific timeframe for collecting variation margin.
Eligible Collateral	Eligible collateral would be restricted to (a) immediately available cash, (b) U.S. obligations or (c) for initial margin only, the debt obligations of Freddie Mac, Fannie Mae, the Federal Home Loan Banks, and Farmer Mac or insured obligations of a Farm Credit System Bank. Additionally, specific haircuts have been proposed for each of these permitted categories of eligible non-cash collateral.	Eligible collateral would be restricted to (a) immediately available cash, (b) U.S. obligations or (c) for initial margin only, the senior debt obligations of Freddie Mac, Fannie Mae, the Federal Home Loan Banks, and Farmer Mac or insured obligations of a Farm Credit System Bank. Additionally, specific haircuts have been proposed for each of these permitted categories of eligible non-cash collateral.	

	Regulatory Proposal		
Regulatory Requirement	**PR Proposal**	**CFTC Proposal**	**Observations and Comments**
	Nonfinancial end users would be required to provide margin required under the PR Proposal in the form of eligible collateral. However, a PR-covered swap entity would be permitted to collect margin that is not required by regulation in any form it agrees to with its counterparty.	A CFTC-covered swap entity may post and accept as initial margin only assets specified in its credit support arrangements with a counterparty that is a nonfinancial entity. Nonfinancial entities would be permitted to post as margin any asset for which "the value is reasonably ascertainable on a periodic basis" as agreed by the parties.	Under the CFTC Proposal, nonfinancial entities would be able to post a broader range of collateral than other entities. For nonfinancial end users whose swap exposure with a PR-covered swap entity surpasses the swap entity's credit threshold, the nonfinancial end user would have to post cash or eligible securities collateral, and could not rely on a letter of credit, security interest or many other arrangements currently used by commercial swap counterparties.
Required Documentation	Swap margin documentation would be required to provide such PR-covered swap entity with the contractual right to collect the margin required by the PR Proposal, specify the means for determining the mark-to-market value of each swap for variation margin requirements and specify a dispute resolution mechanism.[20]	Swap documentation would be required to specify material terms in advance, including the method of margin calculation, the types of assets permitted to be posted, the margin thresholds, if any, and the location where margin will be held.	The Prudential Regulators and the CFTC appear to be proposing different standards for the disclosure of the method of margin calculation. The CFTC's potentially more stringent standard may restrict a CFTC-covered swap entity's ability to adjust its margin models and could be read to require it to publicly disclose proprietary information.

[20] The PR Proposal would also impose special requirements on transactions involving Federal Home Loan Banks, Fannie Mae, Freddie Mac and other entities regulated by the FHFA or FCA. More specifically, any entity regulated by FHFA or FCA (which would include the Federal Home Loan Banks, Fannie Mae and its affiliates, Freddie Mac and its affiliates, and all Farm Credit System institutions including Farmer Mac) that is not itself a swap entity would be required to collect initial and variation margin from swap entity counterparties for non-cleared swaps. Both initial and variation margin posted by a FHFA or FCA-regulated entity would also be required to be segregated with an independent third party custodian located in a jurisdiction that applies the same insolvency regime as would apply to the posting FHFA or FCA-regulated entity. Read literally, this requirement would prohibit a FHFA or FCA-regulated entity from having its margin held by a bank custodian subject to resolution under the Federal Deposit Insurance Act.

	Regulatory Proposal		
Regulatory Requirement	**PR Proposal**	**CFTC Proposal**	**Observations and Comments**
	There is no restriction regarding the use of Courts to resolve disputes (which would, presumably, be the default dispute resolution forum).	The CFTC would also require that the method to calculate initial and variation margin be "stated with sufficient specificity" to allow the counterparty and regulators to calculate the margin requirement independently.	Experience indicates that, particularly in the case of market disruption, the CFTC's objectives may prove illusory and raise legal uncertainty in cases where parties cannot apply the documented method.
Restrictions on the Selection of Custodian	For swaps between a PR-covered swap entity and other swap entities, initial margin would be required to be segregated at an independent third party custodian. The independent third party custodian would be required to be located in a jurisdiction that applies the same insolvency regime to the custodian as would apply to the posting PR-covered swap entity.	For swaps between a CFTC-covered swap entity and other swap entities, initial margin would be required to be segregated at a custodian that is independent of the swap entity and the counterparty. The independent third party custodian would be required to be located in a jurisdiction that applies the same insolvency regime to the custodian as would apply to the CFTC-covered swap entity.	Practical difficulties arise as a result of the requirement that the third-party custodian be located in a certain jurisdiction and subject to a particular insolvency regime.

	Regulatory Proposal		
Regulatory Requirement	**PR Proposal**	**CFTC Proposal**	**Observations and Comments**
			(1) The PR Proposal would require that the custodian be subject to the same insolvency regime as the posting PR-covered swap entity, while the CFTC Proposal would require that the custodian be subject to the same insolvency regime as the CFTC-covered swap entity. This leads, *inter alia*, to an unworkable result for a swap between a PR-covered swap entity and a CFTC-covered swap entity. (2) The requirement that the jurisdiction apply the "same insolvency regime" to the custodian as the posting PR-covered swap entity could be read to prohibit a covered swap entity subject to resolution under the Federal Deposit Insurance Act from having its margin held by a broker-dealer or other entity subject to a different, entity-specific insolvency regime. It is also unclear how this requirement would apply in the case of resolution under the orderly liquidation authority provisions of Title II of Dodd-Frank, since it may not be known *ex ante* whether an entity will be subject to resolution under Title II.

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	Regulatory Proposal		
Regulatory Requirement	**PR Proposal**	**CFTC Proposal**	**Observations and Comments**
			(3) In the case of a cross-border transaction between a PR-covered swap entity and another swap entity, the swap entity collecting margin would be required to hold that margin at a custodian located in the same jurisdiction as its counterparty, thereby giving rise to potential political, legal and other risks with respect to performance of the transaction and rights to the segregated margin collateral.
`	The PR Proposal does not specify an independence standard for custodians.	A CFTC-covered swap entity would be obligated to offer all counterparties the opportunity to select a custodian that is not an affiliate of the CFTC-covered swap entity.	The CFTC Proposal diverges from the CFTC's earlier proposal on segregation of uncleared swaps collateral. Under the earlier proposal, the CFTC did not require that the custodian for segregated initial margin be unaffiliated with the CFTC-covered swap entity. It is unclear whether a custodian that is an affiliate would qualify as an "independent custodian."

	Regulatory Proposal		
Regulatory Requirement	**PR Proposal**	**CFTC Proposal**	**Observations and Comments**
Restrictions on the use of segregated funds	The custodian would be prohibited from rehypothecating or otherwise transferring segregated initial margin and would only be permitted to invest such margin in eligible collateral. The PR Proposal does not indicate whether custodial agreements would be permitted to be bilateral or be required to be tri-party.	The custodian and the swap counterparties would be prohibited from rehypothecating or otherwise transferring segregated initial margin and would only be permitted to invest such margin in eligible collateral. CFTC-covered swap entities would be obliged to enter into tri-party custodial agreements for swaps between CFTC-covered swap entities and other swap entities or financial entities. Bilateral custodial arrangements would be allowed opposite nonfinancial entities.	It is unclear from the Proposals how the prohibition on rehypothecation would apply to cash collateral held by a bank custodian (e.g., would the bank would be required to hold the cash as a "special deposit"?). The CFTC Proposal diverges from the CFTC's earlier proposal on segregation of uncleared swaps collateral. Under that earlier proposal, the CFTC would only have required that there be a written custody agreement between a swap dealer/major swap participant and the custodian, not a tri-party agreement. Some market participants have expressed concern that a secured party holding collateral under a tri-party arrangement may face difficulties obtaining access to collateral during times of market stress. Additionally, regulators have in some contexts suggested that there would be adverse capital treatment for exposures of a registrant secured by collateral that is not in the registrant's possession or under its control, including when that exposure is collateralized but the collateral is held by a third party as custodian.

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	Regulatory Proposal		
Regulatory Requirement	**PR Proposal**	**CFTC Proposal**	**Observations and Comments**
	The PR Proposal would not restrict the use of margin that is not segregated (or required to be segregated).	The CFTC would prohibit a CFTC-covered swap entity from posting initial margin received from a counterparty as margin for other transactions, regardless of whether such initial margin was segregated (or required to be segregated).	The CFTC's additional prohibition on the use of initial margin as margin in another transaction, regardless of the status of the counterparty such margin is received from and whether such margin has been segregated, would prevent a CFTC-covered swap entity from using such margin to support offsetting or hedging transactions. The proposed limitation on rehypothecation of initial margin as margin for hedging purposes seems inconsistent with Dodd-Frank's limitation of the segregation requirements to circumstances in which a counterparty has requested such segregation. It is also unclear what such a limitation would require in practice once counterparty collateral is permissibly commingled with property of the swap entity.

CLEARY GOTTLIEB

Office Locations

New York
One Liberty Plaza
New York, NY 10006-1470
1 212 225 2000
1 212 225 3999 Fax

Washington
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
1 202 974 1500
1 202 974 1999 Fax

Paris
12, rue de Tilsitt
75008 Paris, France
33 1 40 74 68 00
33 1 40 74 68 88 Fax

Brussels
Rue de la Loi 57
1040 Brussels, Belgium
32 2 287 2000
32 2 231 1661 Fax

London
City Place House
55 Basinghall Street
London EC2V 5EH, England
44 20 7614 2200
44 20 7600 1698 Fax

Moscow
Cleary Gottlieb Steen & Hamilton LLC*
Paveletskaya Square 2/3
Moscow, Russia 115054
7 495 660 8500
7 495 660 8505 Fax
* an affiliate of Cleary Gottlieb Steen & Hamilton LLP

Frankfurt
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
49 69 97103 0
49 69 97103 199 Fax

Cologne
Theodor-Heuss-Ring 9
50688 Cologne, Germany
49 221 80040 0
49 221 80040 199 Fax

Rome
Piazza di Spagna 15
00187 Rome, Italy
39 06 69 52 21
39 06 69 20 06 65 Fax

Milan
Via San Paolo 7
20121 Milan, Italy
39 02 72 60 81
39 02 86 98 44 40 Fax

Hong Kong
Bank of China Tower
One Garden Road
Hong Kong
852 2521 4122
852 2845 9026 Fax

Beijing
Twin Towers – West
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
86 10 5920 1000
86 10 5879 3902 Fax

Buenos Aires
CGSH International Legal
Services, LLP-
Sucursal Argentina
Avda. Quintana 529, 4to piso
1129 Ciudad Autonoma de Buenos Aires
Argentina
54 11 5556 8900
54 11 5556 8999 Fax