

CFTC Proposes Cross-Border Margin Rules for Non-Cleared Swaps

On June 29, 2015, the Commodity Futures Trading Commission (“CFTC”) proposed rules (the “Proposal”)¹ addressing the cross-border application of the CFTC’s proposed margin rules (the “CFTC Margin Proposal”)² for swaps not cleared by a registered or exempt derivatives clearing organization (“non-cleared swaps”) entered into by swap dealers (“SDs”) and major swap participants (“MSPs”) that do not have a Prudential Regulator³ (such as SDs and MSPs, “Covered Swap Entities” or “CSEs”). Comments on the Proposal are due by September 14, 2015.

The CFTC Margin Proposal was largely consistent with a proposal by the Prudential Regulators (the “Bank Margin Proposal”)⁴ regarding margin rules for non-cleared swaps and security-based swaps (“SBS”) entered into by SDs, SBS dealers, MSPs and major SBS participants (“Swap Entities”) that have a Prudential Regulator. Those earlier proposals would generally (i) require Swap Entities to exchange two-way initial margin and variation margin with each other and with financial end users, (ii) impose restrictions on the reuse of initial margin and (iii) specify the collateral eligible to satisfy margin requirements.

The Bank Margin Proposal included specific provisions governing the cross-border application of the rules, whereas the CFTC Margin Proposal solicited comments on three conceptual approaches to such issues:

- a “transaction-level” approach consistent with the CFTC’s July 2013 final cross-border guidance (the “Cross-Border Guidance”);⁵
- a “hybrid” approach, consistent with the Bank Margin Proposal, that would apply U.S. margin rules to all swaps activities of CSEs (with a limited exclusion for certain non-U.S. CSEs); and

¹ 80 Fed. Reg. 41376 (July 14, 2015).

² 79 Fed. Reg. 59898 (Oct. 3, 2014).

³ The Prudential Regulators include the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Farm Credit Administration and the Office of the Comptroller of the Currency.

⁴ 79 Fed. Reg. 57348 (Sept. 24, 2014).

⁵ 78 Fed. Reg. 45292 (July 26, 2013).

- an “entity-level” approach that would be similar to the Securities and Exchange Commission’s May 2013 cross-border proposal.⁶

The CFTC has now proposed to follow the hybrid approach contained in the Bank Margin Proposal, with some definitional differences affecting the scope of persons covered by the proposed rules. These differences are discussed in greater detail in Part II below. The extent to which the Prudential Regulators will conform their final margin rules to the Proposal is unclear. It is also not clear whether the Prudential Regulators intend to delay finalization of their rules to take into account comments provided on the Proposal.

The Proposal would depart from the Cross-Border Guidance in several important respects. It would apply U.S. rules more broadly to U.S. firms’ foreign branches and subsidiaries and limit the circumstances in which such entities could rely on substituted compliance. If adopted as proposed, these differences could foster material competitive disparities between U.S. and non-U.S. firms and disrupt cross-border trading activities, especially in the inter-dealer market.

At a minimum, the approach reflected in the Proposal is extremely complex, with many variations in the application of U.S. margin requirements and the availability of substituted compliance. See the matrix attached as **Annex A** depicting the proposed cross-border framework for the application of the CFTC’s margin rules. One might question whether such complexity is necessary given the extent of consistency, viewed holistically, that exists between the CFTC Margin Proposal and the margin rules proposed in key non-U.S. jurisdictions. Indeed, the more stringent the test applied by U.S. regulators in determining whether foreign margin rules are comparable to U.S. rules, the less justification there is for any limitations on the availability of substituted compliance.

It is not clear whether the Proposal presages a broader rethinking by the CFTC of its approach to the application of U.S. transaction-level requirements to cross-border or extraterritorial swaps. As Commissioner Mark Wetjen noted in his statement accompanying the Proposal, firms have incurred substantial costs in building systems that comply with the Cross-Border Guidance, and so modifications would require a costly adjustment. Moreover, although Chairman Timothy Massad indicated that the Proposal reflects the CFTC’s study of the so-called “de-guaranteeing” of foreign subsidiaries that took place following the Cross-Border Guidance, he also emphasized that the approach reflected in the Proposal may not be appropriate with respect to areas of regulation other than margin rules, such as swaps reporting or trading.

⁶ 78 Fed. Reg. 30967 (May 23, 2013).

I. Variations in the Application of Margin Rules Across Covered Swap Entities

The extent to which a CSE would be subject to the CFTC's margin rules, or could comply with those rules through substituted compliance with comparable foreign margin rules, would depend on the CSE's categorization under the Proposal. The Proposal would create five categories of CSEs:

- (1) a U.S. Person⁷ (a "U.S. CSE");
- (2) a non-U.S. CSE whose obligations under the swap are guaranteed⁸ by a U.S. Person (a "Guaranteed Non-U.S. CSE");
- (3) a non-guaranteed, non-U.S. CSE whose operating results, financial position and statement of cash flows are consolidated with those of an ultimate parent entity that is a U.S. Person (a "Foreign Consolidated Subsidiary" or "FCS");⁹
- (4) a U.S. branch of a non-U.S. CSE whose obligations under the swap are not guaranteed by a U.S. Person; or
- (5) a non-U.S. CSE that is neither an FCS nor a U.S. branch and whose obligations under the swap are not guaranteed by a U.S. Person.

The matrix attached as **Annex A** depicts the proposed application of the CFTC's margin rules to counterparty pairs comprising these entities, which we describe in more detail immediately below.

A. U.S. CSEs

Consistent with the Cross-Border Guidance, a U.S. CSE would be subject to the CFTC's margin rules with respect to each non-cleared swap it enters into. As proposed, however, a U.S. CSE could rely on substituted compliance only with respect to its obligation to post initial margin for non-cleared swaps entered into with non-U.S. Persons (including non-U.S. CSEs) whose obligations are not guaranteed by a U.S. Person. In all other cases and respects, including the U.S. CSE's margin collection

⁷ The definition of "U.S. Person" in the Proposal is generally consistent with the definition of the same term in the Cross-Border Guidance, with limited differences discussed in Part II below.

⁸ The proposed definition of the term "guarantee" is discussed in Part II below.

⁹ The proposed definition of the term "Foreign Consolidated Subsidiary" is discussed in Part II below.

obligations, the CFTC's margin rules would apply regardless of whether the transaction would also be subject to comparable foreign margin rules.

B. Foreign Branches of U.S. CSEs

A foreign branch of a U.S. CSE would be treated as part of the U.S. CSE. Accordingly, such branches would be subject to the CFTC's margin rules with respect to all non-cleared swaps, with very limited eligibility for substituted compliance, as noted in the matrix in Annex A. This approach would be much more restrictive than the Cross-Border Guidance, which permits a foreign branch of a U.S. CSE to rely on substituted compliance with comparable foreign rules in connection with every aspect of CFTC rules applicable to its swaps with non-U.S. Persons. As a result, a foreign branch of a U.S. CSE could be subject to U.S. margin rules and comparable foreign margin rules simultaneously, without substituted compliance, and the CFTC has not addressed how a foreign branch should resolve any resulting conflicts between those rules.

In addition, the Cross-Border Guidance contained an "emerging markets" exception from transaction-level CFTC rules, including margin rules. Under this exception, foreign branches of a U.S. SD located outside specified major jurisdictions do not have to comply with those rules when trading with non-U.S. Persons that are also located outside those jurisdictions and that are not guaranteed or conduit affiliates, so long as the U.S. SD's swaps covered by the exception constitute less than 5% of the U.S. SD's quarterly aggregate notional amount of swaps. The Proposal does not include a similar exception, although the CFTC requests comment on whether, and under what conditions, the CFTC should adopt one. Ensuring that the CFTC's (and the Prudential Regulators') final margin rules incorporate this limited exception would appear to be an important objective.

C. Guaranteed Non-U.S. CSEs

A Guaranteed Non-U.S. CSE would be subject to the CFTC's margin rules, and eligible for substituted compliance, to the same extent as a U.S. CSE. As a result, unlike the Cross-Border Guidance, the Proposal would subject a Guaranteed Non-U.S. CSE to the CFTC's margin rules even when trading with a non-U.S. Person that is not a guaranteed or conduit affiliate or registered as an SD. In addition, like a U.S. CSE, a Guaranteed Non-U.S. CSE could only rely on substituted compliance with respect to its obligations to post initial margin. Thus, as is the case for foreign branches of U.S. CSEs, the Proposal would subject Guaranteed Non-U.S. CSEs to a greater risk of duplicative or inconsistent U.S. and foreign margin rules than does the Cross-Border Guidance.

D. Foreign Consolidated Subsidiaries

Like a U.S. CSE and a Guaranteed Non-U.S. CSE, a CSE that is an FCS whose swap obligations are not guaranteed by a U.S. Person would be required to comply with the CFTC's margin rules with respect to each non-cleared swap it enters into, regardless of the status of its counterparty. Unlike those other categories of CSEs, however, an FCS would be eligible for substituted compliance with respect to all aspects of the CFTC's margin rules, unless its counterparty is a U.S. CSE or Guaranteed Non-U.S. CSE.¹⁰ As a result, the Proposal's treatment of FCSs would be most likely to have an adverse impact on FCSs located in jurisdictions that do not implement comparable margin rules or whose margin regime is not found by the CFTC to be comparable to the U.S. margin regime.

E. U.S. Branches

A U.S. branch of a non-U.S. CSE whose obligations under the relevant swap are not guaranteed by a U.S. Person would be subject to the CFTC's margin rules, and be eligible for substituted compliance, to the same extent as an FCS whose obligations are not guaranteed by a U.S. Person. The CFTC has requested comment about how to determine whether non-cleared swaps are entered "through or by" such a U.S. branch. Specifically, the CFTC has requested comment about whether to distinguish a U.S. branch of a non-U.S. CSE from the non-U.S. CSE based on the location of personnel that "arrange, negotiate, or execute" the non-U.S. CSE's non-cleared swaps.¹¹ The CFTC has also requested comment as to whether the U.S. branch of a non-U.S. CSE should be subject to the CFTC's margin rules in connection with non-cleared swaps entered into with a non-U.S. Person that is not an FCS or guaranteed by a U.S. Person.¹²

F. Non-U.S. CSEs

A non-U.S. CSE that is not either (i) an FCS, (ii) trading through its U.S. branch, or (iii) guaranteed by a U.S. Person would not be subject to the CFTC's margin rules in

¹⁰ For non-cleared swaps entered into with a U.S. CSE or a Guaranteed Non-U.S. CSE, an FCS would only be eligible for substituted compliance with respect to its requirement to collect initial margin.

¹¹ The Proposal cites the Volcker Rule as an example of another regulation that applies this "arrange, negotiate, or execute" standard. In addition, the CFTC staff has applied this standard to determine the applicability of certain Title VII requirements. Specifically, in CFTC Advisory 13-69 (Nov. 14, 2013), the CFTC staff took the position that transaction-level requirements would apply to a swap executed between a non-U.S. SD and a non-U.S. counterparty if the swap was regularly "arranged, negotiated, or executed" by personnel or agents located in the United States. That staff position is, however, currently subject to no-action relief in most respects. See CFTC No-Action Letter 14-1440 (Nov. 14, 2014).

¹² For non-cleared swaps entered into with a U.S. CSE or a Guaranteed Non-U.S. CSE, any such non-U.S. CSE would only be eligible for substituted compliance with respect to its requirement to collect initial margin.

connection with non-cleared swaps entered into with a non-U.S. Person that is not (i) an FCS,¹³ (ii) the U.S. branch of a non-U.S. CSE or (iii) guaranteed by a U.S. Person. In addition, like an FCS or a U.S. branch, any such non-U.S. CSE would be eligible for substituted compliance with respect to all aspects of the CFTC's margin rules, unless its counterparty is a U.S. CSE or Guaranteed Non-U.S. CSE.

II. Key Defined Terms

A. "U.S. Person"

The Proposal's "U.S. Person" definition¹⁴ would generally be consistent with the definition of the same term in the Cross-Border Guidance. For example, it would include persons domiciled, organized or with their principal place of business in the United States, including the foreign offices and foreign branches of such persons. However, unlike the Cross-Border Guidance, the definition would not include collective investment vehicles that are not organized or located in the United States but that are majority-owned by U.S. Persons.¹⁵

The Bank Margin Proposal did not use the term U.S. Person, but rather would categorize entities based, in part, on whether they are organized under the laws of the United States or any State.

¹³ Under the Proposal, an FCS would not include a non-U.S. Person that is not a CSE. As a result, unless its obligations were guaranteed by a U.S. Person, a non-U.S. subsidiary of a U.S. Person would not be subject to the CFTC's margin rules when trading non-cleared swaps with a non-U.S. CSE that is not an FCS, the U.S. branch of a non-U.S. CSE or guaranteed by a U.S. Person.

¹⁴ The Proposal would define a "U.S. Person" to mean: (i) any natural person who is a resident of the United States; (ii) any estate of a decedent who was a resident of the United States at the time of death; (iii) any corporation, partnership, limited liability company, business or other trust, association, joint-stock company, fund or any form of entity similar to any of the foregoing (other than an entity described in subparagraph (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 having its principal place of business in the United States, including any branch of such legal entity; (iv) any pension plan for the employees, officers or principals of a legal entity described in subparagraph (iii) of this definition, unless the pension plan is primarily for foreign employees of such entity; (v) any trust governed by the laws of a state or other jurisdiction in the United States, if a court within the United States is able to exercise primary supervision over the administration of the trust; (vi) any 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 subparagraph (i), (ii), (iii), (iv) or (v) of this paragraph 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) any individual account or joint account (discretionary or not) where the beneficial owner (or one of the beneficial owners in the case of a joint account) is a person described in subparagraph (i), (ii), (iii), (iv), (v) or (vi).

¹⁵ Also, prong (vi) of the Proposal's "U.S. person" definition, which would cover a legal entity for which a U.S. Person bears unlimited responsibility for the obligations and liabilities of the legal entity, would not contain the Cross-Border Guidance's requirement that such legal entity be "majority-owned" by U.S. Persons. In addition, the Proposal's "U.S. Person" definition would not include the prefatory phrase "includes, but is not limited to," which was included in the Cross-Border Guidance.

B. “Guarantee”

The Proposal would define a “guarantee” to mean an arrangement pursuant to which a party to a swap with a non-U.S. Person has a legally enforceable right of recourse against a U.S. Person for such non-U.S. Person counterparty’s obligations under that swap. A guarantee would exist even if the guarantor is not affiliated with the guaranteed non-U.S. Person counterparty and whether or not the right of recourse is contingent upon such non-U.S. Person counterparty’s insolvency or failure to meet its obligations under the swap. Covered guarantees would not have to be included in swap documentation or otherwise reduced to writing.

This definition would be somewhat narrower than the Cross-Border Guidance’s definition because it would not include other risk-shifting arrangements, such as keepwells, liquidity puts, certain indemnities, master trust agreements and liability or loss transfer or sharing agreements. The Bank Margin Proposal had requested comment whether to treat these types of arrangements, as well as cross-default clauses, as guarantees.

C. “Foreign Consolidated Subsidiaries”

The Proposal would define the term “Foreign Consolidated Subsidiary” to mean any non-U.S. CSE whose ultimate parent entity¹⁶ is a U.S. Person that includes the non-U.S. CSE’s operating results, financial position and statement of cash flows in the parent entity’s consolidated financial statements, in accordance with U.S. generally accepted accounting principles. This definition would generally be narrower than the Bank Margin Proposal’s parallel concept of a non-U.S. Swap Entity “controlled” by a U.S. person because the Bank Margin Proposal would define “control” to include, among other relationships, equity ownership of 25 percent or more.¹⁷

III. Substituted Compliance

In order for a CSE to rely on substituted compliance in the circumstances described in Part I above, the CFTC would need to determine that the margin rules in the relevant foreign jurisdiction are comparable to the CFTC’s margin rules. Foreign regulators, a CSE or several CSEs acting collectively could request that the CFTC

¹⁶ “Ultimate parent entity” would mean the parent entity in a consolidated group in which none of the other entities in the consolidated group has a controlling interest, under U.S. generally accepted accounting principles.

¹⁷ Specifically, under the Bank Margin Proposal, a company would have “control” of another company if it had: (1) ownership, control, or power to vote 25 percent or more of a class of voting securities of the other company, directly or indirectly or acting through one or more other persons; (2) ownership or control of 25 percent or more of the total equity of the other company, directly or indirectly or acting through one or more other persons; or (3) control in any manner of the election of a majority of the directors or trustees of the other company.

make a comparability determination with respect to some or all of the requirements of the CFTC's margin rules.

To make a comparability determination, the CFTC would begin by analyzing whether the foreign jurisdiction's margin rules conform with the standards adopted by the Basel Committee on Banking Supervision ("BCBS") and the International Organization of Securities Commissions ("IOSCO") in September 2013.¹⁸ After making this threshold determination, the CFTC would analyze the foreign margin rules and make a comparability determination on an "element-by-element" basis, across 11 different elements.¹⁹ Under this approach, the CFTC would not necessarily make a "binary" determination that any foreign margin regime is or is not comparable to the CFTC's margin rules. Rather, the CFTC could permit CSEs to rely on substituted compliance for some but not all elements of the CFTC's margin rules, subject to any conditions the CFTC deems appropriate.

The CFTC's proposed approach to substituted compliance would thus create the possibility that CSEs could be subject to a patchwork of U.S. and foreign margin rules. It also appears to reject the CFTC's earlier professed intent to make comparability determinations based on whether the foreign regulations and U.S. rules "achieve comparable outcomes."²⁰ If this approach is reciprocated by the CFTC's foreign counterparts, it would more closely resemble a 'stricter rule applies' framework, which is, of course, the very antithesis of substituted compliance and mutual recognition and contrary to Congress's intent in admonishing U.S. regulators to seek international harmonization.²¹

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¹⁸ BCBS-IOSCO, Margin requirements for non-centrally cleared derivatives (Sept. 2013).

¹⁹ These elements would be: (1) the transactions subject to the foreign jurisdiction's margin rules; (2) the entities subject to the foreign jurisdiction's margin rules; (3) the methodologies for calculating the amounts of initial and variation margin; (4) the process and standards for approving models for calculating initial and variation margin requirements; (5) the timing and manner in which initial and variation margin must be collected and/or paid; (6) any threshold levels or amounts; (7) risk management controls for the calculation of initial and variation margin; (8) eligible collateral for initial and variation margin; (9) the requirements of custodial arrangements, including rehypothecation and the segregation of margin; (10) documentation requirements relating to margin; and (11) the cross-border application of the foreign jurisdiction's margin rules.

²⁰ See Proposal, 80 Fed. Reg. at 41389. See, also Cross-Border Guidance, 78 Fed. Reg. at 45342 (stating that the CFTC will rely on an "outcomes-based approach" to determine whether foreign regulatory requirements "achieve the same regulatory objectives of the Dodd-Frank Act").

²¹ See Section 752(a) of the Dodd-Frank Act.

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CLEARY GOTTLIEB STEEN & HAMILTON LLP

Annex A: Proposed Cross-Border Application of CFTC Margin Rules

		Counterparty Category			
		U.S. CSE or Guaranteed Non-U.S. CSE	U.S. Person or Guaranteed Non-U.S. Person (not including CSEs)	FCS or U.S. Branch	Non-U.S. Person (but not an FCS or U.S. Branch) not guaranteed by a U.S. Person
Covered Swap Entity Category	U.S. CSE	CFTC margin rules would apply, no substituted compliance	CFTC margin rules would apply, no substituted compliance	CFTC margin rules would apply, substituted compliance only for initial margin <u>posted</u> by the U.S. CSE	CFTC margin rules would apply, substituted compliance only for initial margin <u>posted</u> by the U.S. CSE
	Guaranteed Non-U.S. CSE	CFTC margin rules would apply, no substituted compliance	CFTC margin rules would apply, no substituted compliance	CFTC margin rules would apply, substituted compliance only for initial margin <u>posted</u> by the Guaranteed Non-U.S. CSE	CFTC margin rules would apply, substituted compliance only for initial margin <u>posted</u> by the Guaranteed Non-U.S. CSE
	FCS (not guaranteed by a U.S. Person)	CFTC margin rules would apply, substituted compliance only for initial margin <u>collected</u> by the FCS	CFTC margin rules would apply, substituted compliance available in all respects	CFTC margin rules would apply, substituted compliance available in all respects	CFTC margin rules would apply, substituted compliance available in all respects
	U.S. Branch of Non-U.S. CSE (not guaranteed by a U.S. Person)	CFTC margin rules would apply, substituted compliance only for initial margin <u>collected</u> by the U.S. branch	CFTC margin rules would apply, substituted compliance available in all respects	CFTC margin rules would apply, substituted compliance available in all respects	CFTC margin rules would apply, substituted compliance available in all respects
	Non-U.S. CSE (not a U.S. Branch, an FCS, or guaranteed by a U.S. Person)	CFTC margin rules would apply, substituted compliance only for initial margin <u>collected</u> by the Non-U.S. CSE	CFTC margin rules would apply, substituted compliance available in all respects	CFTC margin rules would apply, substituted compliance available in all respects	CFTC margin rules would <u>not</u> apply

Office Locations

NEW YORK

One Liberty Plaza
New York, NY 10006-1470
T: +1 212 225 2000
F: +1 212 225 3999

WASHINGTON

2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
T: +1 202 974 1500
F: +1 202 974 1999

PARIS

12, rue de Tilsitt
75008 Paris, France
T: +33 1 40 74 68 00
F: +33 1 40 74 68 88

BRUSSELS

Rue de la Loi 57
1040 Brussels, Belgium
T: +32 2 287 2000
F: +32 2 231 1661

LONDON

City Place House
55 Basinghall Street
London EC2V 5EH, England
T: +44 20 7614 2200
F: +44 20 7600 1698

MOSCOW

Cleary Gottlieb Steen & Hamilton LLC
Paveletskaya Square 2/3
Moscow, Russia 115054
T: +7 495 660 8500
F: +7 495 660 8505

FRANKFURT

Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
T: +49 69 97103 0
F: +49 69 97103 199

COLOGNE

Theodor-Heuss-Ring 9
50688 Cologne, Germany
T: +49 221 80040 0
F: +49 221 80040 199

ROME

Piazza di Spagna 15
00187 Rome, Italy
T: +39 06 69 52 21
F: +39 06 69 20 06 65

MILAN

Via San Paolo 7
20121 Milan, Italy
T: +39 02 72 60 81
F: +39 02 86 98 44 40

HONG KONG

Cleary Gottlieb Steen & Hamilton (Hong Kong)
Hysan Place, 37th Floor
500 Hennessy Road, Causeway Bay
Hong Kong
T: +852 2521 4122
F: +852 2845 9026

BEIJING

Cleary Gottlieb Steen & Hamilton LLP
45th Floor, Fortune Financial Center
5 Dong San Huan Zhong Lu
Chaoyang District
Beijing 100020, China
T: +86 10 5920 1000
F: +86 10 5879 3902

BUENOS AIRES

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

SÃO PAULO

Cleary Gottlieb Steen & Hamilton
Consultores em Direito Estrangeiro
Rua Funchal, 418, 13 Andar
São Paulo, SP Brazil 04551-060
T: +55 11 2196 7200
F: +55 11 2196 7299

ABU DHABI

Al Sila Tower, 27th Floor
Abu Dhabi Global Market Square
Al Maryah Island, PO Box 29920
Abu Dhabi, United Arab Emirates
T: +971 2 412 1700
F: +971 2 412 1899

SEOUL

Cleary Gottlieb Steen & Hamilton LLP
Foreign Legal Consultant Office
19F, Ferrum Tower
19, Eulji-ro 5-gil, Jung-gu
Seoul 100-210, Korea
T: +82 2 6353 8000
F: +82 2 6353 8099