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June 6, 2016

CFTC Adopts Final Rules on Application of Margin Requirements for Uncleared Swaps in Cross-Border Transactions

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TO: DERIVATIVES MARKETS ADVISORY COMMITTEE No. 26-16
ICI GLOBAL REGULATED FUNDS COMMITTEE No. 37-16
ICI GLOBAL TRADING & MARKETS COMMITTEE No. 24-16
INTERNATIONAL COMMITTEE No. 31-16
REGISTERED FUND CPO ADVISORY COMMITTEE
SECURITIES OPERATIONS ADVISORY COMMITTEE RE: CFTC ADOPTS FINAL RULES ON APPLICATION OF MARGIN REQUIREMENTS FOR UNCLEARED SWAPS IN CROSS-BORDER TRANSACTIONS

The Commodity Futures Trading Commission (“CFTC”) recently adopted final rules (“Final Rules”) that address the cross-border application of its margin requirements for uncleared swaps (“CFTC’s OTC Margin Rules”). [\[1\]](#) The Final Rules apply to all uncleared swaps of CFTC-registered swap dealers or major swap participants that are not regulated by a prudential regulator (each, a “covered swap entity” or “CSE”). The Final Rules set out the circumstances under which a CSE would be able to comply with the CFTC’s OTC Margin Rules through compliance with comparable foreign requirements (“substituted compliance”), offer certain CSEs a limited exclusion from the CFTC’s OTC Margin Rules, and outline a framework for assessing whether a foreign jurisdiction’s margin requirements are comparable to the CFTC’s requirements.

I. Definition of “U.S. Person”

The extent to which substituted compliance and the limited exclusion are available depends on, among other things, whether the relevant swap involves a “U.S. person.” The Final Rules defines the term generally as proposed to include individuals or entities whose activities have a significant nexus to the U.S. market as a result of being domiciled or organized in the U.S. or by the strength of their connection to the U.S. markets. [\[2\]](#) For regulated funds, the Final Rules look to where a legal entity is organized or incorporated and whether a legal entity that is organized outside the U.S. has a principal place of business in the U.S., to determine if the entity is a U.S. person. The CFTC interprets “principal place of business” to mean the location from which the officers, partners, or

managers of the legal person primarily direct, control, and coordinate the activities of the legal person. In the case of a fund, the CFTC generally would consider the principal place of business to be the United States, if the senior personnel responsible for either (1) the formation and promotion of the fund; or (2) the implementation of the fund's investment strategy are located in the U.S., depending on the facts and circumstances that are relevant to determining the center of direction, control and coordination of the fund.

Thus, the Final Rules did not accept the recommendation of ICI Global to exclude all foreign funds publicly offered only to non-U.S. persons and not offered to U.S. persons (e.g., UCITS) from the definition as in the CFTC guidance on the application of the swap rules to cross-border transactions. [3] The CFTC noted that whether a pool, fund or other collective investment vehicle is publicly offered only to non-U.S. persons and not offered to U.S. persons would not be relevant with respect to the "principal place of business" prong of the U.S. person definition. Accordingly, non-U.S. funds that are offered publicly to non-U.S. persons will be required to analyze their own facts to determine whether they have a principal place of business in the U.S. and are a U.S. person under the CFTC's OTC Margin Rules. [4]

II. Applicability of CFTC's OTC Margin Rules to Cross-Border Uncleared Swaps

The CFTC's cross-border framework was adopted largely as proposed. The availability of substituted compliance under the Final Rules depends on the degree of nexus the CSEs and their counterparties have to the U.S. financial system, as indicated by their status. Under the Final Rules:

- A U.S. CSE or a U.S. CSE whose swap is guaranteed [5] by a U.S. person ("U.S. Guaranteed CSE") would be required to comply with the CFTC's OTC Margin Rules for all uncleared swaps but would be eligible for substituted compliance with respect to the requirement to post (but not the requirement to collect) initial margin for swaps with certain non-U.S. counterparties (referred to herein as "partial substituted compliance").
- A non-U.S. CSE whose obligations under the relevant swap are not guaranteed by a U.S. person would be eligible for substituted compliance unless the counterparty to the swap is a U.S. CSE or U.S. Guaranteed CSE, in which case substituted compliance would be available with respect to the requirement to collect (but not the requirement to post) initial margin (also referred to as "partial substituted compliance").
- A non-U.S. CSE would be eligible for an exclusion from the Final Rules when trading with a non-U.S. person counterparty provided that (a) neither party's obligations under the relevant swap are guaranteed by a U.S. person; (b) neither party is a foreign consolidated subsidiary ("FCS"); [6] and (c) the swap is not conducted by or through a U.S. branch of a non-U.S. CSE.

The CFTC has provided a table that describes how the margin requirements would apply to different counterparties. The table is attached to this memorandum as Appendix A.

A. Uncleared Swaps of U.S. CSEs and U.S. Guaranteed CSEs

The Final Rules would permit U.S. CSEs and U.S. Guaranteed CSEs to use substituted compliance only with respect to the requirement to post (but not the requirement to collect) initial margin, provided that the counterparty is a non-U.S. person whose obligations under the relevant swap are not guaranteed by a U.S. person. The CFTC

believes that substituted compliance is appropriate in these instances because the requirement that the U.S. CSE and U.S. Guaranteed CSE post margin protects the counterparty in the event of default and may reduce transaction costs for U.S. CSEs and U.S. Guaranteed CSEs. The Final Rules, however, do not permit U.S. CSEs and U.S. Guaranteed CSEs to apply substituted compliance to margin collected to ensure that those entities are adequately protected in the event of default of a non-U.S. counterparty. [\[7\]](#)

Therefore, in a transaction involving a U.S. CSE or a U.S. Guaranteed CSE, only transactions with non-U.S. regulated funds (e.g., UCITs) that would not be considered to be U.S. persons could rely on substituted compliance with respect to initial margin posted to (but not collected from) any non-U.S. regulated fund. All other transactions with a U.S. CSE or a U.S. Guaranteed CSE would be subject to the CFTC's OTC Margin Rules.

B. Uncleared Swaps of Non-U.S. CSEs (Including FCSs) Whose Obligations under the Swap are Not Guaranteed by a U.S. Person

The Final Rules would permit substituted compliance when the obligations under an uncleared swap of a non-U.S. CSE (including FCSs) are not guaranteed by a U.S. person and the counterparty is not a U.S. CSE or a U.S. Guaranteed CSE. In permitting substituted compliance, the CFTC recognized the foreign jurisdictions' supervisory interest in CSEs that are domiciled and operating in their jurisdictions, that compliance with two sets of margin regulations may lead to costs and burdens for non-U.S. CSEs not faced by their competitors in the local jurisdictions, and that those costs and burdens may provide disincentives for foreign clients to transact with a non-U.S. CSE.

Therefore, in a transaction involving non-U.S. CSEs (including FCS) whose obligations under the swap are not guaranteed by a U.S. person and a U.S. regulated fund, a non-U.S. regulated fund (considered a U.S. person), or a non-U.S. regulated fund (not considered a U.S. person), the CFTC's OTC Margin Rules would apply but substituted compliance would be available in all circumstances. [\[8\]](#)

C. Exclusions

The Final Rules have an exclusion from the CFTC's OTC Margin Rules for uncleared swaps of non-U.S. CSEs, provided that neither counterparty's obligations under the relevant swap is guaranteed by a U.S. person and neither counterparty is an FCS or a U.S. branch of a non-CSE.

The exclusion was adopted largely as proposed and the CFTC did not expand the exclusion to include FCSs or U.S. branches of non-U.S. CSEs as ICI Global requested. The CFTC considered comments urging a broader scope for the exclusion but did not think extending it to uncleared swaps of FCSs was appropriate given the nature of the subsidiaries' relationship to their U.S. ultimate parent entity and the potential to create a significant supervisory gap and inappropriate levels of risk to the CSE and the U.S. financial system. The CFTC also did not extend the exclusion to uncleared swaps of a U.S. branch of a non-U.S. CSE because, generally speaking, U.S. branches of foreign banks have a prudential regulator and must therefore comply with the prudential regulators' margin rules. Those rules do not grant an exclusion for the uncleared swaps of such U.S. branches because the U.S. branches clearly operate within the U.S. and could pose a risk to the U.S. financial system. The CFTC believed this approach is consistent with the prudential regulators' approach and eliminates a potential disadvantage for U.S. CSEs when competing with U.S. branches of foreign banks for U.S. clients.

Therefore, the Final Rules would not apply the CFTC's OTC Margin Rules to a transaction involving non-U.S. CSEs (that are not FCS or a U.S. branch of a non-U.S. CSE) whose obligations under the swap are not guaranteed by a U.S. person and a non-U.S. regulated fund (e.g., UCITs) that would not be considered a U.S. person.

D. Non-Segregation Jurisdictions

The Final Rules provide a de minimis exception for uncleared swaps involving an FCS or a foreign branch of a U.S. CSE with counterparties in foreign jurisdictions where limitations in the legal or operational infrastructure of the jurisdiction make it impracticable for the CSE and its counterparty to comply with the custodial arrangement requirements under the CFTC's OTC Margin Rules. Specifically, an FCS or a foreign branch of a U.S. CSE would be eligible to engage in uncleared swaps with certain non-U.S. counterparties in these "non-segregation jurisdictions," without complying with either the requirement to post initial margin or the requirement to hold initial margin collected by the CSE with one or more custodians that are not the CSE, its counterparty, or an affiliate of the CSE or its counterparty as the CFTC's OTC Margin Rules require. This exception is available only if each of the following conditions are met:

- 1) inherent limitations in the legal or operational infrastructure of the foreign jurisdiction make it impracticable for the CSE and its counterparty to post any form of eligible initial margin collateral for the uncleared swap pursuant to custodial arrangements that comply with the CFTC's OTC Margin Rules;
- 2) foreign regulatory restrictions require the CSE to transact in uncleared swaps with the counterparty through an establishment within the foreign jurisdiction and do not permit the posting of collateral for the swap in compliance with the CFTC's OTC Margin Rules;
- 3) the CSE's counterparty is a non-U.S. person that is not a CSE and the counterparty's obligations under the swap are not guaranteed by a U.S. person;
- 4) the CSE collects initial margin in cash on a gross basis, and posts and collects variation margin in cash, in accordance with the CFTC's OTC Margin Rules;
- 5) the total outstanding notional value of all uncleared swaps in each of four broad risk categories (i.e., credit, equity, foreign exchange and interest rates -- considered together as a single asset class -- and commodities) does not exceed five percent (5%) of the CSE's total outstanding notional value for all uncleared swaps in the same broad risk category;
- 6) the CSE has policies and procedures ensuring that it is in compliance with each of the requirements of the exception; and
- 7) the CSE maintains books and records properly documenting that all of the requirements of this exception are satisfied.

The CFTC adopted this exception to accommodate the unique circumstances involved and to avoid forcing U.S. CSEs to discontinue their swaps business with clients located in non-segregation jurisdictions, as they could not satisfy the custodial requirements of the CFTC's OTC Margin Rules. To protect the safety and soundness of the FCSs and the foreign branches of the U.S. CSEs, the CFTC imposed the five percent (5%) limit.

E. Non-Netting Jurisdictions

Under the Final Rules, a CSE that cannot conclude, with a well-founded basis, that the netting agreement with a counterparty in a foreign jurisdiction meets the definition of an “eligible master netting agreement” set forth in the CFTC Margin Requirements may nevertheless net uncleared swaps in determining the amount of margin that it posts, provided that certain conditions are met. Specifically, the CSE must treat the 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 in accordance with the netting provisions of the CFTC’s OTC Margin Rules. A CSE that enters into uncleared swaps in “non-netting” jurisdictions in reliance on this provision must have policies and procedures ensuring that it is in compliance with the special provision’s requirements, and maintain books and records properly documenting that all of the requirements are satisfied.

The CFTC chose not to impose a blanket exclusion subject to a percentage limitation based on the level of swap activity because a blanket exclusion could present a significant risk to the safety and soundness of the CSE leaving it without the collection of sufficient margin in the event of a counterparty default.

III. Comparability

The Final Rules outline a framework for the CFTC’s comparability determinations that are nearly identical to the Proposed Rules. The CFTC will make these determinations on a jurisdiction-by-jurisdiction basis. [\[9\]](#) Eligible persons (i.e., any CSE eligible to rely on substituted compliance or any foreign regulatory authorities) may request determinations on an individual or collective basis with respect to some or all of the CFTC’s OTC Margin Rules. Persons requesting comparability determinations should provide: copies of the relevant foreign jurisdiction’s margin requirements and descriptions of their objectives; how they differ from international standards set forth by the Basel Committee on Banking Supervision and the International Organization of Securities; [\[10\]](#) how the relevant foreign jurisdiction’s margin requirements address the various elements of the CFTC’s OTC Margin Rules, identifying the specific legal and regulatory provisions that correspond to each element; [\[11\]](#) and a description of the ability of the relevant foreign regulatory authority or authorities to supervise and enforce compliance with the margin requirements.

The Final Rules also set forth key factors that the CFTC will consider for the determinations, including: the scope and objectives of the relevant foreign jurisdiction’s margin requirements; whether the relevant foreign jurisdiction’s margin requirements achieve comparable outcomes to the CFTC’s corresponding margin requirements; and the ability of the relevant regulatory authority or authorities to supervise and enforce compliance with the relevant foreign jurisdictions’ margin requirements.

In setting forth the framework for these determinations, the CFTC specifically rejected ICI Global’s recommendation that it evaluate and issue a comparability determination for a foreign jurisdiction as a whole rather than on an element-by-element basis, noting the CFTC’s belief that to arrive at a meaningful and complete comparability determination, it must engage in a fact-specific analysis to develop a clear understanding of the elements of the foreign margin regime and how they interact. [\[12\]](#) The CFTC believes this is preferable to an all-or-nothing approach in which the CFTC would be unable to make a comparability determination for an entire jurisdiction if one or more aspects of the foreign jurisdiction’s margin regime results in an outcome that is critically different from those of the CFTC.

In issuing a comparability determination, the CFTC may impose any terms and conditions it deems appropriate. A comparability determination will require that the CFTC be notified of any material changes to information in support of the comparability determination. The CFTC also may, on its own initiative, further condition, modify, suspend, terminate or otherwise restrict a comparability determination in its own discretion. In addition, the Final Rules permit the CFTC to initiate an action if it determines that a CSE has failed to comply with the relevant foreign margin requirements.

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Appendix A- Application of CFTC Margin Requirements for Uncleared Swaps in Cross-Border Transactions

CSE Counterparty Applicable Margin Requirements 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

- 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)

- 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

- 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) Substituted Compliance (Initial Margin collected by CSE in column 1) U.S. (Variation Margin)

- 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, U.S. branch of a non-U.S. CSE, and an FCS) whose obligations under the relevant swap are not guaranteed by a U.S. person

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

- U.S. CSE
- Non-U.S. CSE (including U.S. branch of a non-U.S. CSE and FCS) whose obligations under the swap are guaranteed by a U.S. person

U.S. (Initial Margin posted by CSE in column 1) Substituted Compliance (Initial Margin collected by CSE in column 1) U.S. (Variation Margin)

- 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 (All)

- 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)

endnotes

[1] See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants – Cross Border Application of the Margin Requirements, 81 Fed. Reg. 34855 (May 31, 2016), available at: <https://www.gpo.gov/fdsys/pkg/FR-2016-05-31/pdf/2016-12612.pdf>. For a summary of the proposed rules (“Proposed Rules”), see ICI Memorandum No. 29484 (Sept. 15, 2015), available at: https://www.ici.org/my_ici/memorandum/memo29484. See also, Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 636 (Jan. 6, 2016), available at: <https://www.gpo.gov/fdsys/pkg/FR-2016-01-06/pdf/2015-32320.pdf>. For a summary of the CFTC’s OTC Margin Rules, see ICI Memorandum No. 29587 (Dec. 22, 2015), available at: https://www.ici.org/my_ici/memorandum/memo29587.

[2] The Final Rules define a “U.S. Person” 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 (a)(10)(iv) or (v) of this section) (a “legal entity”), in each case that is organized or incorporated under the laws of the United States or 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 (a)(10)(iii) of this section, unless the pension plan is primarily for foreign employees of such entity;
- v. A trust governed by the laws of a state or other jurisdiction in the United States, if a court within the United States is able to exercise primary supervision over the administration of the trust;
- vi. A legal entity (other than a limited liability company, limited liability partnership or similar entity where all of the owners of the entity have limited liability) that is owned by one or more persons described in paragraphs (a)(10)(i) through (a)(10)(v) of this section and for which such person(s) bears unlimited responsibility for the obligations and liabilities of the legal entity, including any branch of the legal entity; or
- vii. An individual account or joint account (discretionary or not) where the beneficial owner (or one of the beneficial owners in the case of a joint account) is a person described in paragraphs (a)(10)(i) through (a)(10)(vi) of this section.

See 17 CFR § 23.160(a)(10).

[3] See Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 45292 (July 26, 2013) (“Guidance”), available at: <https://www.gpo.gov/fdsys/pkg/FR-2013-07-26/pdf/2013-17958.pdf>. The adopting release does note that non-U.S. funds publicly offered only to non-U.S. persons and not offered to U.S. persons would not fall within any of the prongs of the U.S. person interpretation in the Guidance. See Final Rules, *supra* note 1, n. 51.

[4] The adopting release also clarifies that a person’s status as a U.S. person is determined at the entity level and includes any foreign operations that are part of the legal person, regardless of their location. Subsidiaries and affiliates, however, would not be deemed a U.S. person solely due to their affiliation with a U.S. person.

[5] A “guarantee” generally is 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. See 17 CFR §23.160(a)(2).

[6] A “foreign consolidated subsidiary” is a non-U.S. CSE in which an ultimate parent entity that is a U.S. person has a controlling financial interest, in accordance with U.S. generally accepted accounting principles (“GAAP”), such that the U.S. ultimate parent entity includes the non-U.S. CSE’s operating results, financial position and statement of cash flows in the U.S. ultimate parent entity’s financial statements, in accordance with U.S. GAAP. See 17 CFR §23.160(a)(1).

[7] The CFTC believes that this type of partial substituted compliance would not prohibit the use of a single netting set for calculating initial margin, and that one netting set could encompass swaps that comply with both foreign and CFTC initial margin requirements.

[8] As discussed immediately below, in certain instances, an exclusion to the CFTC’s OTC Margin Rules could apply.

[9] Once a comparability determination is made for a jurisdiction, it will apply for all entities or transactions in that jurisdiction to the extent provided in the determination.

[10] The CFTC clarifies that just because a foreign jurisdiction's margin requirements are consistent with international standards does not mean that they will be comparable to the CFTC's requirements.

[11] The elements are identified as: (A) the products subject to the foreign jurisdiction's margin requirements; (B) the entities subject to the foreign jurisdiction's margin requirements; (C) the treatment of inter-affiliate derivative transactions; (D) the methodologies for calculating the amounts of initial and variation margin; (E) the process and standards for approving models for calculating initial and variation margin; (F) the timing and manner in which initial and variation margin must be collected and/or paid; (G) any threshold levels or amounts; (H) risk management controls for the calculation of initial and variation margin; (I) eligible collateral for initial and variation margin; (J) the requirements of custodial arrangements, including segregation of margin and rehypothecation; (K) margin documentation requirements; and (L) the cross-border application of the foreign jurisdiction's margin regime. See 17 CFR § 23.160(c)(2)(ii).

[12] ICI Global supported an approach that would focus on the regulatory objectives and outcomes of the relevant margin regimes without requiring uniformity with the CFTC's rule provisions, as well as an approach that was less complicated than the CFTC's approach.