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CFTC Proposes Rule on the Application of Margin Requirements for Uncleared Swaps on Cross-Border Transactions

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TO: DERIVATIVES MARKETS ADVISORY COMMITTEE No. 54-15
ICI GLOBAL TRADING & MARKETS COMMITTEE No. 35-15
REGISTERED FUND CPO ADVISORY COMMITTEE
SECURITIES OPERATIONS ADVISORY COMMITTEE RE: CFTC PROPOSES RULE ON THE APPLICATION OF MARGIN REQUIREMENTS FOR UNCLEARED SWAPS ON CROSS-BORDER TRANSACTIONS

The Commodity Futures Trading Commission ("CFTC") recently proposed a new rule ("Proposed Rule") that would apply the CFTC's margin requirements, when adopted, to cross-border transactions. [1] The Proposed Rule would apply the margin requirements to all uncleared swaps of CFTC-registered swap dealers ("SDs") and major swap participants ("MSPs") that are not regulated by a prudential regulator (covered swap entities or "CSEs") in the United States ("U.S. CSEs"), and to certain CSEs outside the United States ("non-U.S. CSEs"). In specified instances, the Proposed Rule would provide eligible CSEs with substituted compliance (i.e., the entity would be permitted to comply with the margin requirements of a foreign jurisdiction if the CFTC determines that those requirements are comparable to the CFTC's margin requirements) or an exclusion from the margin requirements based on the counterparties' nexus to the United States relative to other jurisdictions.

This memorandum briefly describes the aspects of the Proposed Rule that are most relevant to regulated funds, particularly to non-U.S. regulated funds. Specifically, the Proposed Rule may have implications for regulated funds because of the new proposed definition of "U.S. person," which does not contain an exception for publicly offered non-U.S. funds, and the expansion of circumstances in which substituted compliance would be available.

Comments on the Proposed Rule are due 60 days after publication of the Proposed Rule in the Federal Register. ICI Global expects to comment on the Proposed Rule. If you have any specific concerns, please contact Ken Fang at kenneth.fang@ici.org or Jennifer Choi at jennifer.choi@ici.org.

Background

The Proposed Rule follows an earlier re-proposal by the CFTC of proposed margin rules, which included an advanced notice of proposed rulemaking ("ANPR") on the cross-border application of those proposed margin rules. [2] The ANPR sought comment on three approaches to the cross-border application of the CFTC's margin requirements:

1. A transaction-level approach consistent with the CFTC's cross-border guidance ("Guidance Approach"); [3]
2. An approach consistent with the approach proposed by the prudential regulators ("Prudential Regulators' Approach"); [4] and
3. An entity-level approach ("Entity-Level Approach"). [5]

Proposed Rule

The Proposed Rule, as described by the CFTC, is a "hybrid" of the Entity-Level Approach and the Guidance Approach and is closely aligned with the Prudential Regulators' Approach. Departing from the Guidance, the Proposed Rule would apply the margin requirements to a CSE on a firm-wide basis rather than on a transaction-by-transaction basis. The Proposed Rule would, however, permit CSEs to avail themselves of substituted compliance and provide a limited exclusion from the margin rules for uncleared swaps between non-U.S. CSEs and non-U.S. counterparties in certain circumstances.

Definition of U.S. Person

The CFTC proposes to define the term "U.S. person" generally to identify persons that should be subject to the margin rules. The Proposed Rule would define a "U.S. Person" to include those individuals or entities whose activities have a significant nexus to the U.S. market by virtue of their organization or domicile in the United States or the depth of their connection to the U.S. market, even if domiciled or organized outside the United States. [6] The definition is generally consistent with the definition of the term set forth in the Guidance.

With respect to an investment vehicle, the proposed definition would consider a fund to be a U.S. person if it is organized or incorporated under the laws of the United States or has its principal place of business in the United States. Unlike the definition in the Guidance, the new proposed definition does not include the U.S. majority-ownership subsection that was included in the Guidance (i.e., 50% U.S. person ownership of a fund or other collective investment vehicle) [7] and does not include the exclusion from the definition for non-U.S. funds that are publicly offered only to non-U.S. persons and not offered to U.S. persons. [8] Because there is no proposed exclusion for publicly offered non-U.S. funds as in the Guidance, with the proposed new definition, a non-U.S. regulated fund would be required to analyze its own facts and circumstances to determine the location of its principle place of business. In the Proposing Release, the CFTC notes that, in the case of a fund, the principal place of business of a fund would 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 United States, depending on the facts and circumstances that are relevant to determining the center of direction, control, and coordination of the fund.

Application of the Proposed Rule

Uncleared Swaps of U.S. CSEs/Non-U.S. CSEs Whose Obligations under the Swap are Guaranteed by a U.S. Person [9]

The Proposed Rule would apply CFTC margin requirements to all uncleared swap activities of U.S. CSEs and non-U.S. CSEs whose obligations under the swap are guaranteed [10] by a U.S. person, with no exclusions. Substituted compliance would be available with respect to initial margin posted to (but not collected from) any non-U.S. counterparty (including any non-U.S. CSE) whose obligations under the uncleared swap is not guaranteed by a U.S. person.

As a result, the Proposed Rule would apply the CFTC margin rules in the following manner for transactions involving a U.S. CSE (or a non-U.S. CSE whose obligations under the swap are guaranteed by a U.S. person) and various U.S. and non-U.S. regulated funds:

- In a transaction with a U. S. regulated fund, the CFTC's margin requirements would apply and substituted compliance would not be available;
- In a transaction with a non-U.S. regulated fund (e.g., UCITS) that would be considered a "U.S. person" under the proposed rule, the CFTC's margin requirements would apply and substituted compliance would not be available;
- In a transaction with a non-U.S. regulated fund (e.g., UCITS) that would not be considered a "U.S. person" under the proposed rule, the CFTC's margin requirements would apply but substituted compliance would be available with respect to initial margin posted to (but not collected from) any non-U.S. regulated fund.

Uncleared Swaps of Non-U.S. CSEs (including Foreign Consolidated Subsidiaries and U.S. Branches of Non-U.S. CSEs) Whose Obligations under the Swap are not Guaranteed by a U.S. Person [11]

The Proposed Rule would apply CFTC margin requirements to uncleared swaps of non-U.S. CSEs (including Foreign Consolidated Subsidiaries [12] and U.S. branches of non-U.S. CSEs) that are not guaranteed by a U.S. person. The Proposed Rule would permit, however, in these circumstances substituted compliance, except when the counterparty is a U.S. CSE or a non-U.S. CSE whose obligations under the swap are guaranteed by a U.S. person.

Although the CFTC would permit substituted compliance, the CFTC added that uncleared swaps entered into by Foreign Consolidated Subsidiaries would not be eligible for an exclusion from the margin requirements because the financial position, operating results and statement of cash flows of a Foreign Consolidated Subsidiary are incorporated into the financial statements of the U.S. parent entity and have a direct impact on the consolidated entity. Thus, the CFTC has a greater supervisory concern with those entities. In addition, the CFTC does not propose to exclude from the margin rules uncleared swaps entered into by a U.S. branch of a non-U.S. CSE because, under those circumstances, the swap activities occur within the United States and should be subject to U.S. margin laws.

Therefore, under the Proposed Rule, in a transaction involving non-U.S. CSEs (including Foreign Consolidated Subsidiaries and U.S. branches of non-U.S. CSEs) 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 under the Proposed Rule), or non-U.S. regulated fund (not considered a U.S. person), the CFTC's margin requirements would apply but substituted compliance would be available in all circumstances.

Uncleared Swaps of Non-U.S. CSEs Whose Obligations under the Swap and the Obligations of its Counterparty are not Guaranteed by a U.S. Person and Neither Counterparty is a Foreign Consolidated Subsidiary nor a U.S. branch of a Non-U.S. CSE [13]

The Proposed Rule would exclude uncleared swaps of non-U.S. CSEs when neither counterparty's obligations under the swap is guaranteed by a U.S. person and neither counterparty is a Foreign Consolidated Subsidiary or a U.S. branch of a non-U.S. CSE.

Therefore, the Proposed Rule would not apply the CFTC's margin requirements to a transaction involving non-U.S. CSEs (that is not a Foreign Consolidated Subsidiary 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" under the Proposed Rule.

Substituted Compliance

As set forth in the Proposed Rule, the CFTC would permit a U.S. CSE or a non-U.S. CSE, as applicable, to avail itself of substituted compliance. In connection with this, the Proposed Rule establishes a standard of review that would apply to CFTC determinations regarding whether some or all of the relevant foreign jurisdiction's margin requirements are comparable to the CFTC's margin requirements, as well as procedures for requests for comparability determinations, including eligibility and submission requirements. [14]

The Proposed Rule sets forth a comparability standard that is outcome-based with a focus on whether the margin requirements in the foreign jurisdiction achieve the same regulatory objectives as the CFTC's margin requirements and whether a foreign jurisdiction has rules and regulations that achieve comparable outcomes. In evaluating whether a foreign jurisdiction's margin requirements are comparable, the CFTC would consider whether, in light of all relevant facts and circumstances, a foreign jurisdiction has adopted margin rules that adequately follow international standards (based on the Basel Committee on Banking Supervision and the International Organization of Securities Commissions' framework).

Once the CFTC determines that a foreign jurisdiction's margin requirements adhere to these standards, the CFTC would evaluate the various elements of the margin requirements. The CFTC would analyze, among other items: (i) the transactions subject to the jurisdiction's margin requirements; (ii) the entities subject to the foreign jurisdiction's margin requirements; (iii) the methodologies for calculating the amounts of initial and variation margin; (iv) the process and standards for approving models for calculating initial and variation margin models; (v) the timing and manner in which initial and variation margin must be collected and/or paid; (vi) any threshold levels or amount; (vii) risk management controls for the calculation of initial and variation margin; (viii) eligible collateral for initial and variation margin; (ix) the requirements of custodial arrangements, including rehypothecation and segregation of margin; (x) documentation requirements relating to margin; and (xi) the cross-border application of the foreign jurisdiction's margin regime. In addition, the CFTC notes that it would take into consideration all other relevant factors, including any other factors that the CFTC deems relevant.

The Proposed Rule provides that any CSE that is eligible for substituted compliance may request a comparability determination, either individually or collectively, as well as any foreign regulatory authority that has direct supervisory authority over one or more CSEs and that is responsible for setting the foreign jurisdictions margin requirements.

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endnotes

[1] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants (June 29, 2015), available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister062915.pdf ("Proposing Release").

[2] See ICI Memorandum No. 28416 (Sept. 30, 2014), available at https://www.iciglobal.org/iciglobal/pubs/memos/memo28416; See also Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants 79 Fed. Reg. 59898 (Oct. 3, 2014), available at http://www.gpo.gov/fdsys/pkg/FR-2014-10-03/pdf/2014-22962.pdf.

[3] See ICI Memorandum No. 27385 (July 18, 2013), available at https://www.ici.org/my_ici/memorandum/ci.memo27385.print ("ICI Memo 27385"). See also Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 45292 (July 26, 2013), available at http://www.gpo.gov/fdsys/pkg/FR-2013-07-26/pdf/2013-17958.pdf (the "Guidance"). Under this approach, the margin requirements would apply to a U.S. SD/MSP (other than a foreign branch of a U.S. bank that is an SD/MSP) for all of its uncleared swaps, irrespective of whether the counterparty is a U.S. person, without substituted compliance. For a non-U.S. SD/MSP, the margin requirements would only apply to uncleared swaps with a U.S. person counterparty and a non-U.S. counterparty that is a guaranteed affiliate or an affiliated conduit. Where the non-U.S. counterparty is a guaranteed affiliate or an affiliate conduit, the CFTC would permit substituted compliance. Under the Guidance, a "guaranteed affiliate" refers to a non-U.S. person that is an affiliated person of and is guaranteed by a U.S. person. See id. at 45318. A "conduit affiliate" refers to an affiliated person that serves a conduit for a U.S. person as determined based on a variety of factors. See id. at 45319.

[4] Under this approach, the margin requirements would apply to all uncleared swaps of CSEs under the prudential regulators' supervision, except for foreign non-cleared swap of a foreign covered swap entity. This exclusion would only be available when neither the non-U.S. SD/MSP nor the non-U.S. counterparty's obligations are guaranteed by a U.S. person and neither party is controlled by a U.S. person.

[5] Under this approach, the margin requirements would apply on a firm-wide level (i.e., to all uncleared swap activities of a SD/MSP registered with the CFTC), irrespective of whether the counterparty is a U.S. person, and with no possibility of exclusion.

[6] Specifically, the term "U.S. Person" would be defined as:

(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 subparagraph (iv) or (v) of this paragraph) (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) A pension plan for the employees, officers or principals of a legal entity described in subparagraph (iii) of this paragraph, 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 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) 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 subparagraph (i), (ii), (iii), (iv), (v) or (vi).

See Proposed Rule § 23.160(a)(10).

[7] The CFTC's definition of the term "U.S. person" as set forth in the Guidance includes a subsection (iv) which covered "any commodity pool, pooled account, or collective investment vehicle (whether or not it is organized or incorporated in the United States) of which a majority ownership is held, directly or indirectly by a U.S. person(s)." See Guidance supra note 3, at 45302. In addition, the definition does not include the prefactory phrase "includes, but is not limited to" to provide legal certainty regarding the application of U.S. margin requirements to cross-border swaps.

[8] See ICI Memo 27385, supra note 3.

[9] See Proposed Rule § 23.160(b)(1).

[10] The Proposed Rule would define the term "guarantee" as an arrangement pursuant to which one party to a swap transaction with a non-U.S. counterparty has rights of recourse against a U.S. person guarantor (whether such guarantor is affiliated with the non-U.S. counterparty or is an unaffiliated third party) with respect to the non-U.S. counterparty's obligations under the swap transaction. The term would apply whenever a party to the swap has a legally enforceable right of recourse against the U.S. guarantor of a non-U.S. counterparty's obligations under the swap, regardless of whether such right of recourse is conditioned upon the non-U.S. counterparty's insolvency or failure to meet its obligations under the swap, and regardless of whether the counterparty seeking to enforce the guarantee is required to make a demand for payment or performance from the non-U.S. counterparty before proceeding against the guarantor.

[11] See Proposed Rule § 23.160(b)(2).

[12] A "Foreign Consolidated Subsidiary" would be defined as 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 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 consolidated financial

statements, in accordance with GAAP. The term would be used to identify swaps of non-U.S. CSEs whose obligations under the uncleared swap are not guaranteed by a U.S. person but that raise substantial U.S. supervisory concerns due to their potential negative impact on their U.S. parent entities and the U.S. financial system. Under the Proposed Rule, the term "ultimate parent entity" means the parent entity in a consolidated group in which none of the other entities in the consolidated group has a controlling interest, in accordance with GAAP. See Proposed Rule § 23.160(a)(6).

[13] See Proposed Rule § 23.160(b)(2)(ii).

[14] See Proposed Rule § 23.160(c).
