

## Prudential Regulators Are First to Finalize Uncleared Swap Margin Rules

***While the rules provide some clarity, the global market still awaits the finalization of the CFTC and the European margin rules.***

With the clock ticking on the countdown to finalization of uncleared swap margin rules mandated under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), the Prudential Regulators<sup>1</sup> were the first to issue final rules at the end of October,<sup>2</sup> establishing minimum margin requirements for uncleared swaps and uncleared security-based swaps (the PR Margin Rules).<sup>3</sup> The PR Margin Rules apply to swap dealers, security-based swap dealers, major swap participants and major security-based swap participants that are subject to supervision by the Prudential Regulators, such as bank holding companies and insured depository institutions (collectively referred to herein as PR Covered Swap Entities). In an effort to address industry concerns, the Prudential Regulators eased certain aspects of their 2014 proposed rules (the PR Proposed Margin Rules),<sup>4</sup> for example lessening collateral requirements, expanding the collateral eligible to be posted for variation margin in transactions with financial end-users, narrowing the cross-border reach of the rules, raising the initial margin threshold amount and providing some accommodations for inter-affiliate uncleared swaps. These changes bring the rules (including the compliance period) into closer alignment with the recommended international guidelines for uncleared margin published by the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) in September 2013.<sup>5</sup> Compliance with the rules will be phased in over a period of time beginning in September 2016. Though the finalization of the PR Margin Rules is a key piece of the puzzle with respect to the margin framework for uncleared swaps and uncleared security-based swaps, market participants are still waiting for the US Commodity Futures Trading Commission (the CFTC), the US Securities and Exchange Commission (the SEC) and the European regulators to finalize their respective margin rules for uncleared derivatives.

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## I. Summary

### A. PR Margin Rules

The Prudential Regulators first proposed their margin rules in 2011. They then repropose the rules in September 2014, following the publication by BCBS and IOSCO, at the direction of the Group of Twenty (G-20), of international standards for margin requirements for non-centrally cleared derivatives (the International Standards). The International Standards were intended to reduce the opportunity for regulatory arbitrage by creating an international framework for uncleared swaps that regulators could use as a guide to frame their respective margin rules.<sup>6</sup> European regulators also repropose their respective margin requirements for uncleared derivatives (the EMIR Proposed Margin Rules).<sup>7</sup> Prompted by market demand for more time and given the lack of finalized rules in both the US and abroad, in March 2015 BCBS and IOSCO revised the compliance timeline under the International Standards to recommend delaying effectiveness of margin rules by nine months.<sup>8</sup>

Following the recommended timeline of BCBS and IOSCO, the PR Margin Rules will be phased in beginning in September 2016, with the highest-volume dealers that are PR Covered Swap Entities becoming subject to initial margin (IM) and variation margin (VM) requirements first. All market participants, other than commercial end-users and certain exempted small financial institutions, will be required to post VM by March 2017. Market participants subject to IM requirements will become subject to the rules in phases, with the final phase requiring the posting of IM by all such market participants by September 1, 2020.

The PR Margin Rules generally provide that:

- PR Covered Swap Entities entering into uncleared swaps with a person registered (i) with the CFTC as a swap dealer (SD) or a major swap participant (MSP) or (ii) with the SEC as a security-based swap dealer (SBSD) or major security-based swap participant (MSBSP) (SDs, MSPs, SBSBs and MSBSPs collectively referred to herein as Swap Entities),<sup>9</sup> or with Financial End-Users<sup>10</sup> with Material Swaps Exposure (defined below), must collect and post IM<sup>11</sup> and VM<sup>12</sup> on a daily basis.
- PR Covered Swap Entities entering into uncleared swaps with Financial End-Users which do not have Material Swaps Exposure must collect and post daily VM, but will not be required to post or collect IM.

- PR Covered Swap Entities are **not** required to post or collect IM or VM with respect to uncleared swap transactions entered into with commercial end-users and certain small financial institutions.
- For purposes of portfolio margining, counterparties may enter into master netting arrangements that separately account for pre- and post-compliance date positions.
- A more limited cross-border reach than under the PR Proposed Margin Rules.
- PR Covered Swap Entities must collect IM from their affiliates, but do not have to **post** IM unless the affiliate is also a PR Covered Swap Entity. VM must be both collected and posted for inter-affiliate swaps.
- For purposes of these rules, “Affiliate” is defined with a bright-line test, which provides greater legal certainty than under the PR Proposed Margin Rules, in particular for purposes of determining Material Swaps Exposure and IM Threshold Amount (defined below).
- IM must be segregated with independent, non-affiliate custodians.
- For purposes of calculating IM, PR Covered Swap Entities may use approved proprietary margin models instead of the standardized margin schedules provided by the Prudential Regulators in the PR Margin Rules.

The PR Margin Rules will ultimately need to work together with the CFTC<sup>13</sup> and SEC margin rules, which have not yet been adopted, and with the rules of foreign regulators. The CFTC margin rules will apply to registered SDs and MSPs that are not subject to prudential banking regulation, and the SEC margin rules will apply to registered SBSDs and MSBSPs that are not subject to prudential banking regulation, such as foreign banks without a presence in the United States (CFTC Covered Swap Entities and SEC Covered Swap Entities, respectively, and, together with PR Covered Swap Entities, Covered Swap Entities). The CFTC has recently stated that it will adopt final rules in the near future. We expect the final rules to be substantially similar to the PR Margin Rules and, like the PR Margin Rules, generally to align with the International Standards. As a practical matter, the application of the PR Margin Rules or the CFTC margin rules in transactions with financial and non-financial end-users will turn on the regulated status of the bank/financial institution counterparty. Note that the SEC likewise has not yet finalized its uncleared security-based swap margin rules, which have been in proposed form since November 2012.<sup>14</sup>

Except where otherwise noted, we have used the term “uncleared swaps” herein to encompass both (i) swaps<sup>15</sup> that are not cleared by either a derivatives clearing organization<sup>16</sup> registered with the CFTC or by a clearing organization exempted from registration pursuant to the Commodity Exchange Act<sup>17</sup> and (ii) security-based swaps<sup>18</sup> that are not, directly or indirectly, submitted to and cleared by a clearing agency<sup>19</sup> that is either registered with the SEC or that is exempted from registration pursuant to the Securities Exchange Act of 1934.<sup>20</sup>

## **B. Exempted End-Users**

On January 12, 2015, the Terrorism Risk Insurance Program Reauthorization Act of 2015 (TRIPRA) was signed into law.<sup>21</sup> Title III of TRIPRA amends certain provisions of the Dodd-Frank Act to exempt certain counterparties from the IM and VM requirements for uncleared swaps. Specifically, TRIPRA prohibits applying any margin requirements promulgated under the Dodd-Frank Act to uncleared swaps with any of the following counterparties (collectively referred to herein as Exempted End-Users), so long as such counterparty is using the uncleared swaps to hedge commercial risk:

- Commercial end-users, including treasury affiliates acting as agent
- Financial institutions (*i.e.*, small banks, savings associations, Farm Credit System institutions, credit unions) with total assets of US\$10 billion or less and certain financial cooperatives hedging the risks associated with originating loans for their members<sup>22</sup>

Pursuant to TRIPRA, the Prudential Regulators published, concurrently with the PR Margin Rules, an interim final rule (the Interim Final Rule) exempting from the PR Margin Rules certain uncleared swaps and uncleared security-based swaps entered into with Exempted End-Users. The Interim Final Rule is scheduled to go into effect on April 1, 2016. The Prudential Regulators have requested comment on the Interim Final Rule by January 31, 2016.<sup>23</sup> We would expect the Interim Final Rule to be finalized in substantially similar form.

## II. Margin Requirements

### A. Minimum Transfer Amount

The minimum transfer amount below which a PR Covered Swap Entity need not collect or post margin pursuant to the PR Margin Rules with respect to a particular counterparty has been set at US\$500,000 (calculated in the aggregate taking into account all IM and VM required under the PR Margin Rules with respect to such counterparty). This amount has been lowered from US\$650,000, the original amount proposed by the Prudential Regulators in September 2014.<sup>24</sup>

### B. Initial Margin Requirements

#### 1. Posting and Collecting Initial Margin

The PR Margin Rules require that a PR Covered Swap Entity **collect** IM, with respect to any uncleared swap from a counterparty that is either (i) a Financial End-User with Material Swaps Exposure or (ii) a Swap Entity, in an amount that is no less than the greater of either:

- Zero, and
- The IM collection amount (discussed further below) for such uncleared swap, **less** the IM Threshold Amount (defined below) (not including any portion of the IM Threshold Amount already applied by the PR Covered Swap Entity or its Affiliates to other uncleared swaps with the applicable counterparty or its Affiliates), as applicable.

Further, the PR Margin Rules require that a PR Covered Swap Entity **post** IM with respect to any uncleared swap to a counterparty that is a Financial End-User with Material Swaps Exposure, in an amount that is at least as large as what the PR Covered Swap Entity would be required to collect under the PR Margin Rules.<sup>25</sup> The PR Covered Swap Entity will also be required to post margin to CFTC Covered Swap Entities and SEC Covered Swap Entities. However, the amount to be posted to these non-prudentially regulated Swap Entities by PR Covered Swap Entities will be determined under the CFTC or SEC margin requirements (as applicable) which will govern the collection of margin by CFTC Covered Swap Entities and SEC Covered Swap Entities, respectively, in instances when they are facing PR Covered Swap Entities.

**Material Swaps Exposure.** Under the PR Margin Rules, a Financial End-User has “Material Swaps Exposure” if such entity and its Affiliates (defined below), in the aggregate, have an average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange (FX)

forwards<sup>26</sup> and FX swaps<sup>27</sup> with all counterparties for June, July and August of the previous calendar year that exceeds US\$8 billion (calculated only for business days). The PR Proposed Margin Rules originally provided for an exposure calculation in excess of US\$3 billion. The increase in the exposure amount further aligns with the recommended amount of €8 billion under the International Standards.<sup>28</sup> The PR Margin Rules provide for the following adjustments in calculating a Financial End-User's Material Swaps Exposure:

- Inter-affiliate transactions need only be counted once.
- Swaps exempt from the PR Margin Rules by virtue of the Interim Final Rule (*i.e.*, uncleared swaps entered into with Exempted End-Users) should not be included in the calculation.<sup>29</sup>

**Initial Margin Threshold Amount.** Rather than the US\$65 million proposed in the PR Proposed Margin Rules, the Prudential Regulators have lowered the IM Threshold Amount under the PR Margin Rules to mean an aggregate credit exposure of US\$50 million resulting from all uncleared swaps and uncleared security-based swaps between (i) a PR Covered Swap Entity or any of its Affiliates (defined below) and (ii) a counterparty or any of its Affiliates. The Interim Final Rule would **exclude** from this calculation any uncleared swap entered into with Exempted End-Users. The reduction in the IM Threshold Amount is consistent with the International Standards. The IM Threshold Amount may be allocated among entities within a consolidated group at the agreement of the PR Covered Swap Entity and the counterparties, but the total must remain below US\$50 million on a combined basis.<sup>30</sup>

**Inter-affiliate Swaps.** The PR Margin Rules require a PR Covered Swap Entity to collect IM from its Affiliates (defined below) with respect to any inter-affiliate uncleared swap, but do not require such PR Covered Swap Entity to **post** IM to its Affiliates (other than Affiliate counterparties that are also PR Covered Swap Entities). A PR Covered Swap Entity will, however, still be required to calculate the amount that it would have been required to post to an Affiliate in respect of its inter-affiliate uncleared swaps with such Affiliate, and provide that information to such Affiliate on a daily basis.<sup>31</sup> Precisely how the CFTC and the SEC finalize their respective margin rules will determine the scope of this inter-affiliate relief. If the inter-affiliate relief under the to-be-finalized CFTC and SEC margin rules is similar, then the resulting inter-affiliate exemption would be limited to relief from the posting of IM by any Swap Entity to an Affiliate Financial End-User counterparty with Material Swaps Exposure.

- IM Threshold Amount. With respect to uncleared swaps entered into by a PR Covered Swap Entity and its Affiliate, the IM Threshold Amount is equal to an aggregate credit exposure of US\$20 million resulting from all uncleared swaps between such PR Covered Swap Entity and such Affiliate. Any uncleared swaps entered into with an Affiliate that qualifies under the Interim Final Rule would be excluded from this calculation.<sup>32</sup>

**Affiliates.** In an important revision to the PR Proposed Margin Rules, the Prudential Regulators abandoned the control-based approach taken under the proposal, and instead apply a bright-line test to the definition of "Affiliate," whereby a company is considered an "Affiliate" of another company under any of the following conditions:

- Either company consolidates the other on financial statements prepared in accordance with US Generally Accepted Accounting Principles, the International Financial Reporting Standards or other similar standards (referred to collectively herein as Accounting Standards).
- Both companies are consolidated with a third company on a financial statement prepared in accordance with Accounting Standards.

- For a company that is not subject to Accounting Standards, such consolidation would have occurred if such Accounting Standards had applied.
- The applicable Prudential Regulator has determined that such company is an Affiliate of such other company, based on such Prudential Regulator's conclusion that either company provides significant support to, or is materially subject to the risks or losses of, the other company.<sup>33</sup>

The “Affiliate” concept is present throughout the PR Margin Rules, including with respect to IM Threshold Amount, Material Swaps Exposure and special considerations for inter-affiliate uncleared swaps. Abandoning the proposed control test for this bright-line accounting-based approach eliminates legal uncertainty regarding calculating IM Threshold Amount and Material Swaps Exposure on an aggregate basis under the PR Margin Rules.<sup>34</sup> Moreover, as a practical effect, the move away from a control standard creates an objective standard for funds and other investment structures which were potentially going to be subject to IM posting requirements due to the uncertainties in the proposed control-based approach.

## 2. Calculating Initial Margin

A PR Covered Swap Entity may calculate its minimum IM amount under the PR Margin Rules in one of two ways: (i) by using a standardized margin schedule (as set out in Appendix A of the PR Margin Rules and reproduced below), which allows for certain types of netting and offsetting of exposures; or (ii) using an internal margin model that satisfies the PR Margin Rules criteria and that has been approved by the Prudential Regulator for such PR Covered Swap Entity (an approved proprietary margin model).

**Standardized Margin Schedule.** The Prudential Regulators have adopted as proposed the following standardized minimum gross IM requirements for uncleared swaps, as divided by swap asset class.<sup>35</sup>

Asset Class		Gross IM (% of Notional Exposure)
Credit	0-2 year duration	2
	2-5 year duration	5
	5+ year duration	10
Commodity		15
Equity		15
FX/Currency		6
Cross-Currency Swaps <sup>36</sup>	0-2 year duration	1
	2-5 year duration	2
	5+ year duration	4
Interest Rate	0-2 year duration	1
	2-5 year duration	2
	5+ year duration	4
Other		15

- **Eligible Master Netting Agreements.** If the standardized margin schedule is being used to calculate IM for multiple uncleared swaps that are subject to an Eligible Master Netting Agreement (defined below), the amount of IM that must be collected or posted (as applicable) by the PR Covered Swap Entity under the PR Margin Rules is determined according to the following calculation:

$$IM = ( 0.4 \times \text{Gross IM} ) + ( 0.6 \times \text{Net-to-Gross Ratio} \times \text{Gross IM} )^{37}$$

**Approved Proprietary Margin Models.** The PR Margin Rules permit a PR Covered Swap Entity to calculate IM using a proprietary margin model, so long as the applicable Prudential Regulator has granted prior written approval to use the model. . Such approval (which may be revoked) is premised on the model satisfying certain qualitative criteria and minimum control, oversight and validation mechanisms (which the Prudential Regulators adopted substantially as proposed in the PR Proposed Margin Rule) including, *inter alia*:

- The model must determine the potential future exposure of an uncleared swap (or applicable netting portfolio (as discussed further below)), where “potential future exposure” is an estimate of the one-tailed 99% confidence interval for an increase in the value of such uncleared swap (or applicable netting portfolio) over a period equal to the shorter of (i) 10 business days or (ii) the maturity of such uncleared swap (or applicable netting portfolio) (referred to as a holding period). Note that (i) this 10-day holding period is longer than the holding period (*i.e.*, three to five days) which central counterparties typically require and, (ii) unlike under the Prudential Regulators' capital rules, the PR Margin Rules do not permit, under any circumstances, a PR Covered Swap Entity using an approved proprietary margin model to indirectly compute the 10-day horizon by making an IM calculation over a shorter horizon and then scaling such IM calculation to the required 10-day horizon. The PR Margin Rules instead require that such PR Covered Swap Entity's IM calculation be performed directly over the 10-day close-out period.<sup>38</sup>
- If the model reflects offsetting exposures, diversification and other hedging benefits for uncleared swaps that are governed by an Eligible Master Netting Agreement, the PR Covered Swap Entity must demonstrate the reasonableness for modeling and measuring such hedging benefits.
- With respect to an uncleared cross-currency swap, the model need not recognize risks or risk factors associated with the embedded FX swap (*i.e.*, the fixed, physically-settled exchange of principal), but must recognize all material risks associated with all other payments and cash flows under such uncleared cross-currency swap.<sup>39</sup>

The PR Covered Swap Entity must review, at least annually, (i) the data used to calibrate the approved proprietary margin model, to reflect the appropriate period of significant financial stress, (ii) the approved proprietary margin model itself, in light of market development and modeling technologies and also to ensure compliance with the PR Margin Rules and (iii) the internal audit report produced in accordance with the PR Margin Rules.<sup>40</sup>

**Risk Categories.** The PR Margin Rules require that an approved proprietary margin model assign each derivative contract to a single asset class or broad risk category (*i.e.*, FX or interest rate, commodity, credit, equity) and that the IM calculations for derivatives in each broad risk category be performed separately. An approved proprietary margin model is not permitted to reflect offsetting exposures, diversification or other hedging benefits across these broad risk categories.<sup>41</sup> Note that FX and interest rate contracts are considered together as a single asset class for purposes of IM modeling under the PR Margin Rules.<sup>42</sup>

**Eligible Master Netting Agreements.** A PR Covered Swap Entity that uses an approved proprietary margin model to calculate IM under an Eligible Master Netting Agreement may only offset an uncleared swap against other uncleared swaps within the same asset class under such Eligible Master Netting Agreement when calculating IM.<sup>43</sup>

**Inter-affiliate Swaps.** With respect to any uncleared swap entered into with an Affiliate that would have been subject to the clearing requirement but for the inter-affiliate exemption to clearing, a PR Covered

Swap Entity using an approved proprietary margin model may calculate IM by using a holding period equal to the shorter of (i) five business days or (ii) the maturity of such inter-affiliate uncleared swap or the applicable netting portfolio. Netting portfolios for inter-affiliate uncleared swaps that have a holding period calculated in accordance with the foregoing, must be identified and separated from any other netting portfolio for purposes of calculating and complying with the IM requirements under the PR Margin Rules.<sup>44</sup>

Further, to the extent that a PR Covered Swap Entity uses an internal margin model that does not conform with the requirements of the PR Margin Rules, such PR Covered Swap Entity shall calculate (on a daily basis) the IM amount to be collected with respect to uncleared swaps entered into with a given Affiliate, by using the standardized margin schedule and multiplying the Gross IM by 0.7.<sup>45</sup>

### **C. Variation Margin Requirements**

The PR Margin Rules require that a PR Covered Swap Entity collect and post (as applicable) VM in accordance with the PR Margin Rules after such PR Covered Swap Entity has entered into an uncleared swap with a Swap Entity or a Financial End-User (including any Affiliates of such PR Covered Swap Entity<sup>46</sup> and regardless of whether such Financial End-User has Material Swaps Exposure).<sup>47</sup>

#### **Calculating Variation Margin**

The amount of VM which a PR Covered Swap Entity must post or collect (as applicable) with respect to an uncleared swap under the PR Margin Rules is calculated as follows:

- The uncleared swap's cumulative mark-to-market change in value to a PR Covered Swap Entity, as measured from the date such uncleared swap is entered into (or, in the case of an uncleared swap that has a positive or negative value to a PR Covered Swap Entity on the date it is entered into, such positive or negative value plus the uncleared swap's cumulative mark-to-market change in value to the PR Covered Swap Entity after such date), **less**
- The value of all VM previously collected, **plus**
- The value of all VM previously posted with respect to such uncleared swap.<sup>48</sup>

A PR Covered Swap Entity must post and/or collect (as applicable) IM and VM daily, for the life of the uncleared swap.<sup>49</sup>

### **D. Collecting Margin from End-Users**

The Interim Final Rule exempts from the PR Margin Rules those uncleared swaps entered into with Exempted End-Users. For uncleared swaps entered into with counterparties that are not Exempted End-Users but that are, nonetheless, (i) for IM, neither a Swap Entity nor a Financial End-User with Material Swaps Exposure, or (ii) for VM, neither a Swap Entity nor a Financial End-User, the PR Covered Swap Entity must collect IM and VM at such times, in such forms and in such amounts (if any) that the PR Covered Swap Entity determines appropriately addresses the credit risk posed by each such counterparty and the risks of any such uncleared swaps.<sup>50</sup>

## **III. Collateral**

### **A. Market Value and Eligibility of Collateral**

The PR Margin Rules require a PR Covered Swap Entity to monitor the market value and eligibility of all collateral collected and posted to satisfy the IM and VM requirements under the PR Margin Rules. Only



certain types of assets satisfy these requirements, and the eligibility of the collateral differs based on the type of margin (IM or VM) being posted and/or collected and, with respect to VM, the identity of the PR Covered Swap Entity's counterparty. To the extent that either (i) the market value of such collateral has declined or (ii) such collateral no longer qualifies as Eligible Collateral, PR Covered Swap Entities are required to collect or post sufficient collateral to remain compliant with the PR Margin Rules.<sup>51</sup>

### **Eligible Collateral**

The final rules expand the scope of collateral that PR Covered Swap Entities may post or collect (Eligible Collateral) beyond the original proposal.

- **Initial Margin.** PR Covered Swap Entities may post and collect the following types of collateral to satisfy their IM obligations under the PR Margin Rules:
  - Immediately available cash funds denominated in US Dollars or another major currency,<sup>52</sup> or the currency of settlement<sup>53</sup> under the uncleared swap (referred to herein as the settlement currency) (unless noted otherwise, such funds are referred to herein as cash collateral)<sup>54</sup>
  - Securities issued or guaranteed by a US government agency, the European Central Bank (ECB) or certain sovereign entities<sup>55</sup>
  - Certain debt securities and asset-backed securities issued by US government-sponsored enterprises (GSEs)<sup>56</sup>
  - Interests in pooled investment funds that invest in US government securities or securities issued by the ECB or certain sovereign entities (referred to herein as Eligible Investment Fund Interests)<sup>57</sup>
  - Certain corporate debt securities<sup>58</sup>
  - Securities issued or guaranteed by the Bank for International Settlements, the International Monetary Fund or a multilateral development bank<sup>59</sup>
  - Certain listed equities<sup>60</sup>
  - Gold<sup>61</sup>

Many of these types of collateral are subject to significant Haircuts to reflect their liquidity and market valuation risk. We discuss these Haircuts later in this Client Alert.

- **Variation Margin.** As noted above, the scope of Eligible Collateral for VM under the PR Margin Rules varies depending on the identity of such PR Covered Swap Entity's counterparty:
  - Swap Entity: A PR Covered Swap Entity may only post and collect cash collateral for purposes of satisfying VM requirements for uncleared swaps entered into with a Swap Entity.
  - Financial End-User with Material Swap Exposure: A PR Covered Swap Entity may post and collect the following forms of collateral to satisfy VM requirements for uncleared swaps entered into with a Financial End-User with Material Swaps Exposure:
    - Cash collateral
    - Non-cash collateral that is eligible to satisfy the above IM requirements<sup>62</sup>

- **Ineligible Securities.** The following securities are specifically excluded from the definition of Eligible Collateral under the PR Margin Rules:
  - Securities issued by (i) the party pledging such collateral (the posting counterparty) or (ii) an Affiliate of the posting counterparty
  - Securities issued by a wide range of US and non-US financial entities and market intermediaries, including banks, bank holding companies, brokers, dealers, SDs and futures commission merchants, in an effort to avoid the wrong-way risk that may depress the value of such securities in a financial crisis<sup>63</sup>

## **B. Collateral Segregation**

The PR Margin Rules require that IM posted or collected by a PR Covered Swap Entity (including collateral in excess of that required by the PR Margin Rules) be segregated at one or more custodians that are not Affiliates of either the PR Covered Swap Entity or its counterparty (such custodian is referred to as a third-party custodian).<sup>64</sup>

### **Custodial Agreement**

The IM must be posted subject to a custodial agreement that satisfies the following conditions:

- The custodial agreement prohibits the third-party custodian from rehypothecating, repledging, reusing or otherwise transferring any of the collateral it holds, **except** that cash collateral may be held in a general deposit account with the third-party custodian if (i) the funds in the account are used to purchase an asset qualifying as Eligible Collateral, (ii) such Eligible Collateral is not otherwise rehypothecated, repledged or reused and (iii) such purchase takes place within a time period reasonably necessary to consummate such purchase after the cash collateral is posted as IM.
- If the custodial agreement permits the posting party to substitute or direct any reinvestment of collateral held by the third-party custodian pursuant to the PR Margin Rules, the custodial agreement may only permit the substitution or reinvestment of such collateral in assets (i) that would qualify as Eligible Collateral or (ii) for which the amount net of applicable Haircuts would be sufficient to meet the IM requirements under the PR Margin Rules.<sup>65</sup>

### **Unavailability of Segregation Under an Applicable Foreign Jurisdiction**

Under certain circumstances where segregation of margin is unavailable, the PR Margin Rules provide an exception to the IM posting requirement with respect to uncleared swaps involving certain non-US counterparties. This exception only applies to uncleared swaps entered into by either (i) a foreign branch of a PR Covered Swap Entity that is a depository institution<sup>66</sup> or (ii) a PR Covered Swap Entity that is not organized under the laws of the United States or any State<sup>67</sup> and that is a subsidiary (defined below) of a depository institution, Edge corporation<sup>68</sup> or Agreement corporation.<sup>69</sup> To qualify for this exception, all of the following conditions must be present with respect to the uncleared swap(s) in question:

- Limitations in the legal or operational structure of the applicable foreign jurisdiction would not practically allow the PR Covered Swap Entity and its counterparty to post any form of IM in compliance with the segregation requirements under the PR Margin Rules.
- The PR Covered Swap Entity is subject to foreign regulatory restrictions that (i) require such PR Covered Swap Entity to transact in uncleared swaps through an establishment within the applicable foreign jurisdiction and (ii) do not accommodate the posting of collateral outside such foreign jurisdiction.

- The counterparty to the uncleared swap is not, and the counterparty's obligations under the uncleared swap are not, guaranteed by either (i) an entity organized under the laws of the United States or any State (such entity referred to herein as a US entity), including a US branch, agency or subsidiary of a foreign bank, (ii) a natural person who is a US resident or (iii) a branch or office of a US entity.
- Such PR Covered Swap Entity, as required by the PR Margin Rules, both collects IM and posts and collects VM, in each case in the form of cash collateral.

In order to rely on this exception, the PR Covered Swap Entity must have received the applicable Prudential Regulator's prior written approval.<sup>70</sup>

### Custody Arrangements for Inter-affiliate Swaps

To the extent that a PR Covered Swap Entity collects non-cash collateral from an Affiliate to satisfy its IM collection requirements under the PR Margin Rules, the custodian for such non-cash collateral may be such PR Covered Swap Entity or an Affiliate thereof.<sup>71</sup>

### C. Collateral Valuation

The value of any Eligible Collateral is calculated as follows:

$$\text{Collateral Value} = \text{Eligible Collateral Market Value} \times (1 - \text{Applicable Haircut}),$$

with such value expressed in percentage terms (referred to herein as Collateral Value). The total value of all IM or VM collateral collected or posted pursuant to the PR Margin Rules is calculated as the sum of the Collateral Values of each item of Eligible Collateral.<sup>72</sup>

### Haircuts

The value of any Eligible Collateral collected or posted to satisfy the PR Margin Rules is subject to the sum of the following discounts (such discounts referred to herein as Haircuts):

Asset Class		Discount (%)
VM collateral denominated in a currency that is not the settlement currency (except for immediately available cash funds denominated in US Dollars or another major currency)		8.0
IM collateral denominated in a currency that is not the settlement currency (except for Eligible Collateral denominated in a single termination currency designated as payable to the collecting counterparty under an Eligible Master Netting Agreement)		8.0
Eligible government and related debt	Residual maturity <1 year	0.5
	Residual maturity 1-5 years	2.0
	Residual maturity >5 years	4.0
Certain eligible GSE debt securities and other eligible publicly traded debt	Residual maturity <1 year	1.0
	Residual maturity 1-5 years	4.0
	Residual maturity >5 years	8.0
Equity included in the S&P 500 or a related index		15.0
Equity included in the S&P 1500 Composite or a related index (but not the S&P 500 or related index)		25.0
Gold		15.0

- **Haircuts for Eligible Investment Fund Interests.** The Haircut for any Eligible Investment Fund Interests under the PR Margin Rules is the weighted average Haircut on all assets within the relevant eligible investment fund at the end of the prior month, with the weights applied in the weighted average calculated as a fraction of the fund's total market value that is invested in each asset with a given Haircut.<sup>73</sup>

## IV. Netting Arrangements and Retroactive Application

The PR Margin Rules permit a PR Covered Swap Entity to net multiple uncleared swaps with a counterparty that is a Swap Entity or a Financial End-User for purposes of calculating IM and VM amounts and of posting or collecting margin, so long as all uncleared swaps netted against each other have been executed pursuant to an Eligible Master Netting Agreement entered into as between such PR Covered Swap Entity and such counterparty.<sup>74</sup> Note that IM amounts may not be netted against VM amounts (and vice versa) under the PR Margin Rules.<sup>75</sup>

### A. Eligible Master Netting Agreements

In response to industry market concerns, the PR Margin Rules have aligned the definition of “Eligible Master Netting Agreement” with that of the definition of “qualified master netting agreement” as used in the Prudential Regulators’ risk-based capital rules.<sup>76</sup> An “Eligible Master Netting Agreement” means a legally enforceable agreement for which the following conditions are satisfied:

- Upon an event of default following any permitted stay (discussed below), the agreement creates a single legal obligation for all transactions entered into under such agreement.
- The agreement provides the PR Covered Swap Entity the right (i) to accelerate, terminate and close-out on a net basis all transactions under such agreement and (ii) to liquidate or set-off collateral promptly upon an event of default, including upon an event of receivership, conservatorship, insolvency, liquidation or similar proceeding, of the counterparty. Upon the occurrence of any such proceeding, the agreement shall provide that any exercise of rights under such agreement will not be stayed or avoided under applicable law in the relevant jurisdictions, except under either of the following circumstances:
  - In receivership, conservatorship or resolution under the Federal Deposit Insurance Act, Title II of the Dodd-Frank Act, the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, as amended, or the Farm Credit Act of 1971, as amended, or laws of foreign jurisdictions that are substantially similar to the foregoing in order to facilitate the orderly resolution of the defaulting counterparty
  - The agreement is subject by its terms to, or incorporates, any of the laws referenced above (any such stay referred to herein as a permitted stay)
- The agreement does not contain a walkaway clause (*i.e.*, a provision that permits a non-defaulting counterparty to make a lower payment than it otherwise would make under the agreement, or no payment at all, to a defaulter or the estate of a defaulter, even if the defaulter or the estate of the defaulter is a net creditor under the agreement).

The Prudential Regulators have removed the condition in the PR Proposed Margin Rules that the master netting agreement could not contain a clause which allowed the suspension or conditioning of payment. This proposed clause had previously caused much concern among market participants, as it would have precluded the ISDA Master Agreement from qualifying as an Eligible Master Netting Agreement, given

Section 2(a)(iii) of the ISDA Master Agreement which allows for suspending payments under a default scenario.<sup>77</sup>

A PR Covered Swap Entity that relies on an Eligible Master Netting Agreement to calculate the margin required under the PR Margin Rules must:

- Conduct sufficient legal review to conclude with a well-founded basis (and maintain sufficient written documentation of that legal review) that each of the following conditions has been met:
  - The agreement satisfies the requirements of the “Eligible Master Netting Agreement” definition
  - In the event of a legal challenge (including one resulting from default or from receivership, conservatorship, insolvency, liquidation or similar proceeding), the relevant court and administrative authorities would find the agreement to be legal, valid, binding and enforceable under the law of the relevant jurisdictions
- Establish and maintain written procedures to monitor possible changes in relevant law and to ensure that the agreement continues to satisfy the requirements of the “Eligible Master Netting Agreement” definition<sup>78</sup>

## **B. No Retroactive Application to Previously Executed Uncleared Swaps**

The PR Margin Rules permit a PR Covered Swap Entity to identify separate netting portfolios (*i.e.*, there can be multiple groups of uncleared swaps that are netted only against the other uncleared swaps in their respective group, even if two or more groups of uncleared swaps were executed pursuant to the same Eligible Master Netting Agreement) in a way that precludes the retroactive application of the PR Margin Rules to uncleared swaps entered into before the applicable compliance date for the PR Covered Swap Entity in respect of its counterparty under the Eligible Master Netting Agreement at issue. For example, if the uncleared swaps under a particular Eligible Master Netting Agreement entered into between a PR Covered Swap Entity and a counterparty (that is a Swap Entity or a Financial End-User) is divided into two netting portfolios — (1) uncleared swaps entered into before the compliance date applicable to such PR Covered Swap Entity in respect of such counterparty (the pre-compliance portfolio) and (2) uncleared swaps entered into on or after the applicable compliance date (the post-compliance portfolio) — the PR Covered Swap Entity is permitted to only net the uncleared swaps in the post-compliance portfolio against other post-compliance uncleared swaps, and the uncleared swaps in the pre-compliance portfolio against other pre-compliance uncleared swaps. Thus, PR Covered Swap Entities can continue to use an existing Eligible Master Netting Agreement after the applicable compliance date(s) without effectively subjecting the pre-compliance trades thereunder to the PR Margin Rules.<sup>79</sup>

## **Legacy Swaps**

The Prudential Regulators expressly declined to exempt new swap transactions arising from amendments to and novations or compressions of uncleared swaps entered into prior to the applicable compliance date (legacy swaps) from the PR Margin Rules; as such, the following transactions will be subject to the PR Margin Rules beginning on the applicable compliance date, despite their relationship to any legacy swap, to the extent such transactions give rise to a new swap transaction (note the list below is not necessarily exhaustive):

- Amendments to legacy swaps
- Novations of legacy swaps
- New derivatives resulting from portfolio compression of legacy swaps<sup>80</sup>

## V. Documentation

### A. Swap Documentation

Consistent with documentation standards under the Dodd-Frank Act, the PR Margin Rules require a PR Covered Swap Entity to document margin-related matters. Such documentation must satisfy the following requirements:

- Provide such PR Covered Swap Entity and its counterparty with the contractual right to collect and post IM and VM in such amounts, in such form and under such circumstances as are required by the PR Margin Rules
- Specify the methods, procedures, rules and inputs used for determining the value of each uncleared swap for purposes of calculating IM and VM
- Specify the procedures by which any disputes concerning uncleared swap valuation or margin amounts may be resolved<sup>81</sup>

### B. Approved Proprietary Margin Models

If a PR Covered Swap Entity calculates IM under the PR Margin Rules by using an approved proprietary margin model, then such PR Covered Swap Entity must adequately document the following additional items with respect to such model:

- All material aspects of such approved proprietary margin model, including (i) the management and valuation of the uncleared swaps to which the model applies, (ii) the control, oversight and validation of such model and (iii) any review processes and the results of such processes
- Internal authorization procedures (including escalation procedures) that require review and approval of any change to the IM calculation under such approved proprietary margin model, demonstrable analysis that any basis for any such change is consistent with the PR Margin Rules and independent review of such demonstrable analysis and approval<sup>82</sup>

## VI. Cross-Border Application

As proposed in September 2014, the Prudential Regulators have expressly exempted Foreign Uncleared Swaps (defined below) from the PR Margin Rules.<sup>83</sup> Cross-border swaps that do not qualify for this exemption may otherwise qualify for substituted compliance (but only with respect to posting IM) under the PR Margin Rules, as further discussed below.

### A. Relevant Definitions

#### Foreign Uncleared Swaps

A foreign uncleared swap or foreign uncleared security-based swap (referred to collectively herein as Foreign Uncleared Swaps) means any uncleared swap with respect to which neither the counterparty nor the Foreign Covered Swap Entity (defined below) nor any party providing a guarantee of either party's relevant uncleared swap obligations falls under the following categories:

- A US entity (including a US branch, agency or subsidiary of a foreign bank)<sup>84</sup>
- A natural person who is a US resident
- A branch or office of a US entity
- A Swap Entity that is a subsidiary of a US entity<sup>85</sup>

## Foreign Covered Swap Entity

A Foreign Covered Swap Entity means a PR Covered Swap Entity that is not:

- A US entity (including a US branch, agency or subsidiary of a foreign bank)
- A branch or office of a US entity
- An entity that is a Subsidiary of US entity<sup>86</sup>

The final rules adopt a definition of Foreign Uncleared Swap and Foreign Covered Swap Entity nearly identical to the definitions proposed in September 2014, except that the final rules remove the concept of “control” in the last prong and replace it with a “subsidiary” concept. The practical effect of this is that certain entities organized outside of the United States and managed or controlled by a US entity, but that are **not** consolidated on the balance sheets of the US entity, will qualify as a Foreign Covered Swap Entity. The changes to these definitions could create substantial benefits to funds organized outside of the United States but managed by US managers. However, the Prudential Regulators do leave themselves some flexibility to make discretionary decisions regarding the definition of “Subsidiary” in the third prong.

## Subsidiary

A company is considered a “Subsidiary” of another company under the PR Margin Rules if any of the following is true:

- Such company is consolidated by the other company on financial statements prepared in accordance with Accounting Standards.
- For a company that is not subject to Accounting Standards, such consolidation would have occurred if such Accounting Standards had applied.
- The applicable Prudential Regulator has determined that such company is a subsidiary of the other company, based on such Prudential Regulator's conclusion that either company provides significant support to, or is materially subject to the risks of loss of, the other company.<sup>87</sup>

## Guarantee

The PR Margin Rules include a definition of “guarantee” that the Prudential Regulators had not previously proposed. For purposes of Foreign Uncleared Swaps and other cross-border applications of the PR Margin Rules, the Prudential Regulators have defined “guarantee” to mean an arrangement pursuant to which one party to an uncleared swap has rights of recourse, with respect to its counterparty's obligations under the applicable uncleared swap (referred to herein as relevant swap obligations), against a third-party guarantor of such relevant swap obligations, provided that:

- A party to an uncleared swap has “rights of recourse” against such guarantor if such party has a conditional or unconditional legally enforceable right to receive or otherwise collect, in whole or in part, payments from the guarantor with respect to its counterparty's relevant swap obligations.
- If such guarantor has a conditional or unconditional legally enforceable right to receive or otherwise collect, in whole or in part, payments from any other third-party guarantor with respect to such counterparty's relevant swap obligations under another arrangement, such other arrangement will also be deemed a “guarantee” (and such other guarantor will also be deemed a “guarantor”) of such counterparty's relevant swap obligations.<sup>88</sup>

This definition of “guarantee” is limited and would not capture liquidity puts or credit backstops that do not **expressly** provide a counterparty with a right of recourse.<sup>89</sup>

## **B. Substituted Compliance**

The PR Margin Rules permit a PR Covered Swap Entity to request a joint determination from the Prudential Regulators that such PR Covered Swap Entity's obligations to **post** (but not collect) IM under the PR Margin Rules would be satisfied by complying with the margin requirements of a foreign jurisdiction relevant to an uncleared swap entered into by such PR Covered Swap Entity (*i.e.*, substituted compliance) (such margin requirements referred to herein as the applicable foreign margin rules).<sup>90</sup> A PR Covered Swap Entity would be deemed to have **posted** IM to satisfy its obligations under the PR Margin Rules if the following requirements are met:

- Such PR Covered Swap Entity posts to its counterparty IM in the form and amount, and at such times, that such counterparty is required to collect IM pursuant to the applicable foreign margin rules (provided that such counterparty is subject to the applicable foreign margin rules and the Prudential Regulators have made a substituted compliance determination under the PR Margin Rules, unless otherwise stated in such determination).
- Such counterparty's obligations under the uncleared swap are not guaranteed by either (i) a US entity (including a US branch, agency or subsidiary of a foreign bank), (ii) a natural person who is a US resident or (iii) a branch or office of a US entity.<sup>91</sup>

As finalized, the PR Margin Rules do not provide for substituted compliance determinations with respect to a PR Covered Swap Entity's margin **collection** obligations. The Prudential Regulators have stated that they will take a holistic view of the applicable foreign margin rules in making their joint substituted compliance determination and will consider the following factors on a case-by-case basis for each foreign jurisdiction in question:

- Whether the outcomes achieved by the applicable foreign margin rules are comparable to those achieved by the PR Margin Rules
- The scope, objectives and specific provisions of the applicable foreign margin rules
- The effectiveness of the supervisory compliance program administered and of the enforcement authority which the applicable foreign regulatory authorities exercise<sup>92</sup>

Eligible PR Covered Swap Entities (as discussed below) can request a substituted compliance determination under the PR Margin Rules only if the uncleared swap activities of such PR Covered Swap Entity are directly supervised by the foreign regulatory authorities administering the applicable foreign margin rules.<sup>93</sup>

The practical cross-border application of the PR Margin Rules will need to consider the overlay of the CFTC's finalized margin rules for uncleared swaps (the cross-border approach to uncleared swap margin rules which the CFTC proposed earlier this year was notably different than the approach that the Prudential Regulators have finalized in the PR Margin Rules)<sup>94</sup> as well as the finalized rules for uncleared derivatives under EMIR.

### **Requests for Determination**

In requesting a substituted compliance determination under the PR Margin Rules, a PR Covered Swap Entity must submit the following information to the Prudential Regulators:



- The scope and objectives of the applicable foreign margin rules
- The specific provisions of the applicable foreign margin rules that govern (i) the scope of transactions covered, (ii) the determination of the amount of IM and VM required and how such amount is calculated, (iii) the timing of margin requirements, (iv) any documentation requirements, (v) the forms of eligible collateral, (vi) any segregation and rehypothecation requirements and (vii) the approval process and standards for models used in calculating IM and VM
- The supervisory compliance program and enforcement authority exercised by the applicable foreign financial regulatory authority (or authorities) in such system to support oversight of the application of the applicable foreign margin rules and how such applicable foreign margin rules apply to the PR Covered Swap Entity's uncleared swaps
- Any other description and documentation that the Prudential Regulators determine are appropriate<sup>95</sup>

### Eligible PR Covered Swap Entities

A PR Covered Swap Entity is eligible to request a substituted compliance determination pursuant to the PR Margin Rules only if it satisfies the following conditions:

- The PR Covered Swap Entity's obligations under the uncleared swap are not guaranteed by either (i) a US entity (other than a US branch or agency of a foreign bank), (ii) a natural person who is a US resident or (iii) a branch or office of a US entity.
- The PR Covered Swap Entity is either (i) a Foreign Covered Swap Entity, (ii) a US branch or agency of a foreign bank or (iii) an entity that (a) is not a US entity and (b) is a subsidiary of a depository institution, Edge corporation or Agreement corporation.<sup>96</sup>

## VII. Phased-in Compliance Period

Consistent with the International Standards, the phased-in compliance schedule repropoed by the Prudential Regulators in September 2014 has been extended under the PR Margin Rules. The compliance dates for the IM and VM requirements under the PR Margin Rules will be based on the average daily notional amount of uncleared swaps, uncleared security-based swaps, FX forwards and FX swaps (computed for business days only) for each counterparty (aggregated with its respective Affiliates), as set out below:<sup>97</sup>

	Variation Margin Compliance Date	Initial Margin Compliance Date
<b>AVERAGE DAILY AGGREGATE NOTIONAL AMOUNT</b>		
Exceeding US\$3 trillion <sup>a</sup>	Sept. 1, 2016	Sept. 1, 2016
Exceeding US\$2.25 trillion <sup>b</sup>	March 1, 2017	Sept. 1, 2017
Exceeding US\$1.5 trillion <sup>c</sup>		Sept. 1, 2018
Exceeding US\$750 billion <sup>d</sup>		Sept. 1, 2019
Any amount		Sept. 1, 2020

<sup>a</sup> Calculated for March, April and May 2016

<sup>c</sup> Calculated for March, April and May 2018

<sup>b</sup> Calculated for March, April and May 2017

<sup>d</sup> Calculated for March, April and May 2019

### A. Calculating Average Daily Aggregate Notional Amount

For purposes of determining the applicable compliance date, a PR Covered Swap Entity would take into account the average daily aggregate notional amounts of the following transactions:

- Uncleared swaps
- Uncleared security-based swaps
- FX forwards
- FX swaps

Additionally, the PR Margin Rules provide for the following adjustments in calculating the average daily aggregate notional amounts:

- Inter-affiliate transactions need only be counted once.
- Swaps exempt from the PR Margin Rules by virtue of the Interim Final Rule (*i.e.*, uncleared swaps entered into with Exempted End-Users) would not be included in the calculation.

### **Divergence from International Standards**

Note that the applicable compliance date under the PR Margin Rules is determined based on the average daily aggregate notional amount of uncleared swaps, whereas the International Standards proposed compliance dates determined by the aggregate **month-end** average notional amount of non-centrally cleared derivatives.

### **B. Ongoing Compliance Obligations**

Once a PR Covered Swap Entity is subject to the PR Margin Rules with respect to a particular counterparty by virtue of the above compliance schedule, such PR Covered Swap Entity will remain subject to the PR Margin Rules with respect to such counterparty, regardless of the average daily aggregate notional amount with respect to that particular counterparty or the PR Covered Swap Entity itself. **However**, in the event that a counterparty's status changes in a way that would subject any uncleared swaps entered into by the PR Covered Swap Entity with such counterparty to "less strict" margin requirements under the PR Margin Rules (*e.g.*, the counterparty is a Financial End-User that previously had, but no longer has, Material Swaps Exposure), then the PR Covered Swap Entity may comply with the "less strict" margin requirements for: (i) any uncleared swaps entered into after such counterparty's status change and (ii) any outstanding uncleared swaps entered into after the applicable compliance date and before such counterparty changed its status.<sup>98</sup>

## **VIII. EU Margin Rules and Cross-Border Issues**

EU regulators have not yet issued the finalized margin requirements for uncleared derivatives under EMIR, despite having published two public consultations and having originally indicated that they expected to submit the final draft of the EMIR margin rules to the European Commission in September or October of this year.<sup>99</sup> Given the international pressure posed by the finalization of the PR Margin Rules and the International Standards themselves setting a phased-in compliance schedule beginning in September 2016, we expect these rules to be finalized by early 2016.

Globally, regulators have been working together to impose comparable margin requirements in respect of uncleared swaps in their respective jurisdictions. In each case, the International Standards serve as a guide and a regulatory framework on which to base local jurisdiction rules. To date, the EU and Japan have each proposed uncleared swap margin requirements.<sup>100</sup> Many other jurisdictions are expected to follow suit in light of the G-20 commitments.<sup>101</sup>

Market participants who operate internationally will need to understand the interplay among the margin rules at a global level, which regimes such counterparties may be subject to and what, if any, differential treatment may exist between a hedging strategy that faces, for instance, an EU bank, on the one hand, and a US bank, on the other, depending on the location of their uncleared swap counterparties. While both US and non-US regulators seek to establish comparable rules, largely following the International Standards in an effort to reduce duplication and the possibilities of regulatory arbitrage and competitive advantage, harmonizing margin regulation across the globe has proven to be a very difficult task. Moreover, market participants have raised concerns regarding the effective application of uncleared swap margin rules globally within the envisaged timeframe, in the absence of harmonization and substituted compliance.

In fact, the PR Margin Rules, the CFTC Proposed Margin Rules and the EMIR Proposed Margin Rules each have material differences. For instance, under the PR Margin Rules, an exemption from the margin requirements will apply to swaps between PR Covered Swap Entities and foreign counterparties, provided that no US entity guarantees either party's relevant swap obligations. As a practical matter, then, certain offshore funds possibly would not be required to post margin when trading with certain non-US banks, because the EMIR Proposed Margin Rules currently would not require certain investment funds to post IM or VM. However, the EU regulators have recently stated that they are revisiting the treatment of certain entities currently classified as non-financial counterparties (including some investment funds and securitization vehicles), which may eventually close this potential gap in the rules. Further, in the EU, physically-settled FX swaps and forwards are subject to the margin requirements, while in the US such instruments would not require posting of margin; this is only one of several discrepancies among the various uncleared swap margin regimes. Moreover, until rules are finalized in the EU and other foreign jurisdictions and the US regulators have determined whether compliance with such rules would satisfy US margin rules, we will not have clarity on which jurisdiction's rules apply in cross-border circumstances.

Further, even within the United States, the finalized cross-border application of the PR Margin Rules differ from the CFTC's proposal with respect to the cross-border reach of the CFTC Proposed Margin Rules. The market will need to wait for the finalized CFTC and SEC margin rules in order to understand the extraterritorial application of the US margin rules as a whole, the availability of substituted compliance and whether the US regulators (i.e., the CFTC, the SEC and the Prudential Regulators) are aligned in their approach.

The imposition of margin requirements on uncleared swaps is one of the most, if not **the** most important regulation affecting the uncleared swaps market since the passage of the Dodd-Frank Act. While the market gears up for compliance with uncleared swap margin rules there is still a bit of a "wait and see" approach in the cross-border context as we wait for the global framework to be finalized.

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## Endnotes

- <sup>1</sup> The term “Prudential Regulators” as used herein means the Office of the Comptroller of the Currency (Department of Treasury) (the OCC), the Board of Governors of the Federal Reserve System (the FRB), the Federal Deposit Insurance Corporation (the FDIC), the Farm Credit Administration (the FCA) and the Federal Housing Finance Agency (the FHFA). 12 C.F.R. § \_\_.2 (citing 7 U.S.C. § 1a(39)).
- <sup>2</sup> The FDIC, the OCC and the FCA approved the final rule establishing margin for uncleared swaps on October 22, 2015 and the FRB and the FHFA followed suit on October 30, 2015. See Joint Press Release: Agencies Finalize Swap Margin Rule (Oct. 30, 2015), available at <http://www.federalreserve.gov/newsevents/press/bcreg/20151030b.htm>.
- <sup>3</sup> At publication, the Prudential Regulators' uncleared swap margin rules have not yet been published in the Federal Register. A copy of the final rules as approved by the Prudential Regulators can be found in the Prudential Regulators' joint press release: Margin and Capital Requirements for Covered Swap Entities (approved Oct. 30, 2015) (to be codified at 12 C.F.R. pts. 45, 237, 349, 624, 1221), available at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20151030b1.pdf> (PR Margin Rules).
- <sup>4</sup> Margin and Capital Requirements for Covered Swap Entities, 79 Fed. Reg. 57348 (proposed Sept. 24, 2014) (proposing amendment of 12 C.F.R. pts. 45, 237, 349, 624, 1221), available at <http://www.gpo.gov/fdsys/pkg/FR-2014-09-24/pdf/2014-22001.pdf> (PR Proposed Margin Rules). For further discussion, please refer to our *Client Alert* on the repropoed uncleared swap margin rules. UPDATE: Swap Dealers Will Face Significant Challenges from Repropoed Margin Rules for Uncleared Swaps, *Client Alert* No. 1792 (Jan. 26, 2015), available at <http://www.lw.com/thoughtLeadership/lw-dealers-margin-rules-for-uncleared-swaps>.
- <sup>5</sup> See PR Margin Rules at 41.
- <sup>6</sup> Margin Requirements for Non-Centrally Cleared Derivatives (updated March 2015), available at <http://www.bis.org/bcbs/publ/d317.pdf> (International Standards).
- <sup>7</sup> Draft Regulatory Technical Standards on Risk-Mitigation Techniques for OTC-Derivative Contracts Not Cleared by a CCP Under Article 11(15) of Regulation (EU) No 648/2012 (proposed April 14, 2014), available at <https://www.eba.europa.eu/documents/10180/655149/JC+CP+2014+03+%28CP+on+risk+mitigation+for+OTC+derivatives%29.pdf>; Second Consultation Paper: Draft Regulatory Technical Standards on Risk-Mitigation Techniques for OTC-Derivative Contracts Not Cleared by a CCP Under Article 11(15) of Regulation (EU) No 648/2012 (proposed June 10, 2015), available at <https://www.eba.europa.eu/documents/10180/1106136/JC-CP-2015-002+JC+CP+on+Risk+Management+Techniques+for+OTC+derivatives+.pdf> (EMIR Proposed Margin Rules).
- <sup>8</sup> See International Standards.
- <sup>9</sup> 12 C.F.R. § \_\_.2; see PR Margin Rules at 48-49.
- <sup>10</sup> The PR Margin Rules define “Financial End-User” to include the following counterparties:
  - Bank holding companies (or Affiliates thereof)
  - Savings and loan holding companies
  - Certain US intermediate holding companies
  - Certain nonbank financial institutions supervised by the FRB
  - Depository institutions
  - Foreign banks
  - Federal or state credit unions
  - Certain institutions functioning solely in a trust or fiduciary capacity
  - Industrial loan companies, industrial banks or similar institutions
  - State-licensed or registered credit or lending entities
  - State-licensed or registered money services businesses
  - Entities regulated by the FHFA
  - Institutions regulated by the FCA
  - Securities holding companies
  - Brokers or dealers
  - Investment advisers
  - Registered investment companies, certain securitization vehicles or certain private real estate investment entities
  - Business development companies
  - Private funds relying on Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act; mortgage-related funds (including some REITs) relying on Section 3(c)(5)(C) of the Investment Company Act; and issuers of asset-backed securities relying on Rule 3a-7 under the Investment Company Act.

- Commodity pools, commodity pool operators or commodity trading advisors
- Floor brokers, floor traders or introducing brokers
- Futures commission merchants
- Employee benefit plans
- Insurance companies or other entities primarily engaged in writing insurance or reinsuring risks underwritten by insurance companies or that are otherwise subject to supervision as an insurance company by an insurance regulator
- Entities, persons or arrangements that are, or hold themselves out as being, an entity, person or arrangement that raises money from investors, accepts money from clients or uses its own money primarily for the purpose of investing or trading or facilitating the investing or trading in loans, securities, swaps, funds or other assets for resale or other disposition, or otherwise trading in loans, securities, swaps, funds or other assets
- Foreign entities that would be considered Financial End-Users or Swap Entities if they were organized in the United States

The term Financial End-User expressly **excludes** any counterparty that is:

- A sovereign entity
- A multilateral development bank
- The Bank for International Settlements
- An entity that is exempt from the definition of “financial entity” under the Commodity Exchange Act
- An Affiliate that qualifies for the inter-affiliate exemption from clearing

12 C.F.R. § \_\_.2; see PR Margin Rules at 49-64; 7 U.S.C. §§ 1a(10)-(12), (22), (23), (28), (31), 2(h)(7)(C)(iii), 2(h)(7)(D); 12 U.S.C. §§ 1467a(n), 1752(1), 1752(6), 1813(c), 1841, 1850a, 2001 *et seq.*, 4502(20), 5323; 15 U.S.C. §§ 78c(a)(4)-(5), 78c-3(g)(4), 80a-1 *et seq.*, 80a-3(c)(5)(C), 80a-53(a), 80b-2(a); 29 U.S.C. §§ 1002(3)(3), (3)(32); 12 C.F.R. § 252.153; 17 C.F.R. § 270.3a-7.

<sup>11</sup> “Initial margin” is defined in the PR Margin Rules to mean collateral as calculated in accordance with a permitted IM margin model that is posted or collected in connection with an uncleared swap. 12 C.F.R. § \_\_.2.

<sup>12</sup> “Variation margin” is defined in the PR Margin Rules to mean collateral provided by one party to its counterparty to meet the performance of its obligations under one or more uncleared swaps between the parties as a result of a change in value of such obligations since the last time such collateral was provided. 12 C.F.R. § \_\_.2.

<sup>13</sup> See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 Fed. Reg. 59898 (proposed Oct. 3, 2014), available at <http://www.gpo.gov/fdsys/pkg/FR-2014-10-03/pdf/2014-22962.pdf> (CFTC Proposed Margin Rules).

<sup>14</sup> Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, 77 Fed. Reg. 70214 (proposed Nov. 23, 2012) (proposing amendment of 17 C.F.R. pt. 240), available at <http://www.gpo.gov/fdsys/pkg/FR-2012-11-23/pdf/2012-26164.pdf> (SEC Proposed Margin Rules).

<sup>15</sup> See 7 U.S.C. § 1a(47).

<sup>16</sup> See 7 U.S.C. § 1a(15).

<sup>17</sup> 12 C.F.R. § \_\_.2; see 7 U.S.C. §§ 7a-1(a), (h).

<sup>18</sup> See 15 U.S.C. § 78c(a)(68).

<sup>19</sup> See 15 U.S.C. § 78c(a)(23).

<sup>20</sup> 12 C.F.R. § \_\_.2; see PR Margin Rules at 71-73; 15 U.S.C. §§ 78q-1(b)(1), (k).

<sup>21</sup> Terrorism Risk Insurance Program Reauthorization Act of 2015, Pub. L. No. 114-1, § 302 (2015).

<sup>22</sup> See PR Margin Rules at 18-19; see also 7 U.S.C. §§ 2(h)(7)(A), (D), 6(c)(1); 15 U.S.C. § 78c-3(g); 17 C.F.R. § 50.51.

<sup>23</sup> At publication, the Prudential Regulators' uncleared swap margin rules have not yet been published in the Federal Register. A copy of the interim final rule as approved by the Prudential Regulators can be found in the Prudential Regulators' joint press release: Margin and Capital Requirements for Covered Swap Entities (approved Oct. 30, 2015) (to be codified at 12 C.F.R. pts. 45, 237, 349, 624, 1221), available at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20151030b2.pdf> (Interim Final Rule); see PR Margin Rules at 32-35.

<sup>24</sup> 12 C.F.R. § \_\_.5(b); PR Margin Rules at 109-110.

<sup>25</sup> 12 C.F.R. § \_\_.3(b); see 12 C.F.R. §§ \_\_.3(d), \_\_.9(d)(4); PR Margin Rules at 86-88.

<sup>26</sup> See 7 U.S.C. § 1a(24).

<sup>27</sup> See 7 U.S.C. § 1a(25).

<sup>28</sup> See International Standards at 10, 25.

<sup>29</sup> 12 C.F.R. § \_\_.2; see PR Margin Rules at 64-71.

<sup>30</sup> 12 C.F.R. § \_\_.2; see 12 C.F.R. § \_\_.1(d); PR Margin Rules at 88-92, 97-99.

<sup>31</sup> 12 C.F.R. § \_\_.11(b); see PR Margin Rules at 179-187.

- 32 12 C.F.R. § \_\_.11(b)(2).
- 33 12 C.F.R. § \_\_.2.
- 34 See PR Margin Rules at 74-79.
- 35 See PR Margin Rules at 154-161.
- 36 "Cross-currency swap" is defined in the PR Margin Rules to mean a swap in which one party exchanges with another party principal and interest rate payments in one currency for principal and interest rate payments in another currency, and the exchange of principal occurs on the date the swap is entered into, with a reversal of the exchange of principal at a later date that is agreed upon when the swap is entered into. 12 C.F.R. § \_\_.2; see PR Margin Rules at 79.
- 37 "Gross IM" is equal to the sum of the product of each uncleared swap's effective notional amount and the gross IM requirement for all uncleared swaps subject to the Eligible Master Netting Agreement; "Net-to-Gross Ratio" is the ratio of the net current replacement cost to the gross current replacement cost, where "net current replacement cost" equals the total replacement cost for all uncleared swaps subject to the Eligible Master Netting Agreement and "gross current replacement cost" equals the sum of the replacement cost for each uncleared swap subject to the Eligible Master Netting Agreement for which the cost is positive (except if the gross current replacement cost is zero, the NGR should be set to 1.0). 12 C.F.R. pt. \_\_, App. A, n. 1.
- 38 12 C.F.R. § \_\_.8(d)(1); see PR Margin Rules at 141-142.
- 39 See PR Margin Rules at 152-153.
- 40 12 C.F.R. § \_\_.8(b)-(f); see PR Margin Rules at 135-154.
- 41 12 C.F.R. § \_\_.8(d)(3); see PR Margin Rules at 143-150.
- 42 See PR Margin Rules at 135, 143.
- 43 12 C.F.R. § \_\_.8(d)(3); see PR Margin Rules at 143.
- 44 12 C.F.R. § \_\_.11(e); see PR Margin Rules at 181-182, n. 154.
- 45 12 C.F.R. § \_\_.11(f).
- 46 See 12 C.F.R. § \_\_.11(c).
- 47 See PR Margin Rules at 99-101.
- 48 12 C.F.R. § \_\_.2 (definition of "variation margin amount"); see PR Margin Rules at 101-103.
- 49 12 C.F.R. §§ \_\_.3(c), \_\_.4(b).
- 50 12 C.F.R. §§ \_\_.3(d), \_\_.4(c); see 12 C.F.R. § \_\_.6(f); PR Margin Rules at 103-105, 124-125.
- 51 12 C.F.R. § \_\_.6(e).
- 52 "Major currency" is defined in the PR Margin Rules to mean the US Dollar (USD), the Canadian Dollar (CAD), the Euro (EUR), the UK Pound (GBP), the Japanese Yen (JPY), the Swiss Franc (CHF), the New Zealand Dollar (NZD), the Australian Dollar (AUD), the Swedish Kroner (SEK), the Danish Kroner (the DKK), the Norwegian Krone (NOK) or any other currency as determined by the PR Covered Swap Entity's applicable Prudential Regulator. 12 C.F.R. § \_\_.2; see PR Margin Rules at 79-80.
- 53 "Currency of settlement" is defined in the PR Margin Rules to mean a currency in which a party has agreed to discharge payment obligations related to an uncleared swap or a group of uncleared swaps subject to a master agreement at the regularly occurring dates on which such payments are due in the ordinary course. 12 C.F.R. § \_\_.2.
- 54 12 C.F.R. §§ \_\_.6(a)(1), (b)(1).
- 55 12 C.F.R. §§ \_\_.6(a)(2)(i)-(iii), (b)(2)-(4). The PR Margin Rules define "sovereign entity" to mean a central government (including the US government) or an agency, department, ministry or central bank of a central government. 12 C.F.R. § \_\_.2.
- 56 12 C.F.R. §§ \_\_.6(a)(2)(iv)-(v), (b)(5)-(6). The PR Margin Rules define "US government-sponsored enterprise" to mean an entity established or chartered by the US government to serve public purposes specified by federal statute but whose debt obligations are not explicitly guaranteed by the full faith and credit of the US government. 12 C.F.R. § \_\_.2; see PR Margin Rules at 85.
- 57 12 C.F.R. §§ \_\_.6(a)(2)(viii), (b)(9).
- 58 12 C.F.R. §§ \_\_.6(a)(2)(vii)(A), (b)(8)(i).
- 59 12 C.F.R. §§ \_\_.6(a)(2)(vi), (b)(7). "Multilateral development bank" is defined in the PR Margin Rules to mean the International Bank for Reconstruction and Development, the Multilateral Investment Guarantee Agency, the International Finance Corporation, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the European Bank for Reconstruction and Development, the European Investment Bank, the European Investment Fund, the Nordic Investment Bank, the Caribbean Development Bank, the Islamic Development Bank, the Council of Europe Development Bank and any other entity that provides financing for national or regional development in which the US government is a shareholder or contributing member or which the PR Covered Swap Entity's applicable Prudential Regulator determines poses comparable credit risk. 12 C.F.R. § \_\_.2.
- 60 12 C.F.R. §§ \_\_.6(a)(2)(vii)(B), (b)(8)(ii).
- 61 12 C.F.R. §§ \_\_.6(a)(2)(ix), (b)(10); see PR Margin Rules at 113-120.
- 62 See 12 C.F.R. § \_\_.6(b); PR Margin Rules at 111-113.

- <sup>63</sup> 12 C.F.R. § \_\_.6(d). Securities issued by the following entities are excluded from the scope of Eligible Collateral under the PR Margin Rules: (i) bank holding companies, (ii) savings and loan holding companies, (iii) US intermediate holding companies established or designated for purposes of compliance with 12 C.F.R. § 252.153, (iv) foreign banks, (v) depository institutions, (vi) market intermediaries, (vii) companies that would be fall under the foregoing categories if organized under the laws of the United States or any State, (viii) Affiliates of any of the foregoing institutions or (ix) nonbank financial institutions supervised by the FRB under 12 U.S.C. § 5323. 12 C.F.R. § \_\_.6(d)(2)-(3).
- <sup>64</sup> 12 C.F.R. § \_\_.7(a)-(b); see PR Margin Rules at 125-135.
- <sup>65</sup> 12 C.F.R. § \_\_.7(c)-(d).
- <sup>66</sup> See 12 U.S.C. § 1813(c).
- <sup>67</sup> “State” is defined in the PR Margin Rules to mean any State, commonwealth, territory or possession of the United States, the District of Columbia, the Commonwealth of Puerto Rico, the Commonwealth of the Northern Mariana Islands, American Samoa, Guam or the US Virgin Islands. 12 C.F.R. § \_\_.2; see PR Margin Rules at 85.
- <sup>68</sup> An “Edge corporation” is an organization operating under Section 25A of the Federal Reserve Act. See PR Margin Rules at n. 4.
- <sup>69</sup> An “Agreement corporation” is an organization having an agreement with the FRB under Section 25 of the Federal Reserve Act. See PR Margin Rules at n. 4.
- <sup>70</sup> 12 C.F.R. § \_\_.9(f); see PR Margin Rules at 174-176.
- <sup>71</sup> 12 C.F.R. § \_\_.11(d).
- <sup>72</sup> 12 C.F.R. § \_\_.6(c)(2); see PR Margin Rules at 120-124.
- <sup>73</sup> The PR Margin Rules provide the following example of calculating the Haircut for Eligible Investment Fund Interests: for an eligible investment fund comprised solely of US\$100 of 91-day Treasury bills and US\$100 of 3-year US Treasury bonds,  
$$\text{Haircut} = [ (100 / 200 ) \times 0.5 ] + [ (100 / 200 ) \times 2.0 ] = ( 0.5 \times 0.5 ) + ( 0.5 \times 2.0 ) = 1.25 \text{ percent}$$
- 12 C.F.R. pt. \_\_, App. B, n. 1.
- <sup>74</sup> 12 C.F.R. § \_\_.5(a)-(b); see PR Margin Rules at 105-109.
- <sup>75</sup> See PR Margin Rules at n. 152.
- <sup>76</sup> See PR Margin Rules at 81; see 12 C.F.R. pts. 3.2, 217.2, 324.2; Regulatory Capital Rules, Liquidity Coverage Ratio: Interim Final Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions, 79 Fed. Reg. 78287 (Dec. 30, 2014), available at <http://www.gpo.gov/fdsys/pkg/FR-2014-12-30/pdf/2014-30218.pdf>; Regulatory Capital Rules, Liquidity Coverage Ratio: Proposed Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions, 80 Fed. Reg. 5063 (proposed Jan. 30, 2015), available at <http://www.gpo.gov/fdsys/pkg/FR-2015-01-30/pdf/2015-01324.pdf>.
- <sup>77</sup> See PR Margin Rules at 82-83, n. 125.
- <sup>78</sup> 12 C.F.R. § \_\_.2 (citing 12 U.S.C. §§ 1811 *et seq.*, 2183, 2279cc, 4617, 5381 *et seq.*); see PR Margin Rules at 80-84.
- <sup>79</sup> 12 C.F.R. § \_\_.5(3); see PR Margin Rules at 44-45.
- <sup>80</sup> See PR Margin Rules at 41-42.
- <sup>81</sup> 12 C.F.R. § \_\_.10; see PR Margin Rules at 176-179.
- <sup>82</sup> 12 C.F.R. § \_\_.8(g)-(h).
- <sup>83</sup> See PR Margin Rules at 162-165.
- <sup>84</sup> The PR Margin Rules define “foreign bank” to mean an organization that is organized under the laws of a foreign country and that engages directly in the business of banking outside the United States. 12 C.F.R. § \_\_.2; see PR Margin Rules at 73-74.
- <sup>85</sup> 12 C.F.R. § \_\_.9(b).
- <sup>86</sup> 12 C.F.R. § \_\_.9(c).
- <sup>87</sup> 12 C.F.R. § \_\_.2; see PR Margin Rules at 74-79.
- <sup>88</sup> 12 C.F.R. § \_\_.9(g).
- <sup>89</sup> See PR Margin Rules at 165-167.
- <sup>90</sup> 12 C.F.R. § \_\_.9(a); see PR Margin Rules at 168-174.
- <sup>91</sup> 12 C.F.R. § \_\_.9(d)(4).
- <sup>92</sup> See PR Margin Rules at 173-174; 12 C.F.R. § \_\_.9(d)(2).
- <sup>93</sup> 12 C.F.R. § \_\_.9(e)(2).
- <sup>94</sup> See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants--Cross-Border Application of the Margin Requirements (proposed July 14, 2015), available at <http://www.gpo.gov/fdsys/pkg/FR-2015-07-14/pdf/2015-16718.pdf>. For further discussion, please refer to our *Client Alert* regarding the CFTC’s proposed cross-border application of the margin rules. CFTC Proposes Cross-Border Application of Margin Requirements for Uncleared Swaps, *Client Alert* No. 1865 (Aug. 13, 2015), available at <https://www.lw.com/thoughtLeadership/lw-CFTC-Cross-Border-Application-Uncleared-Swaps>.
- <sup>95</sup> 12 C.F.R. § \_\_.9(e)(1).



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<sup>96</sup> 12 C.F.R. § \_\_.9(d)(3).

<sup>97</sup> See PR Margin Rules at 35-46.

<sup>98</sup> See PR Margin Rules at 42-44.

<sup>99</sup> See Presentation given by the European Supervisory Authorities at the Public Hearing on EMIR - Risk mitigation techniques for non-centrally cleared OTC derivatives, Slide 5 (June 18, 2015), *available at* [http://www.esa.europa.eu/news-press/calendar?p\\_p\\_auth=GQqZ0Umj&p\\_p\\_id=8&p\\_p\\_lifecycle=0&p\\_p\\_state=normal&p\\_p\\_mode=view&\\_struts\\_action=%2Fcalendar%2Fview\\_event&\\_struts\\_eventId=1106183](http://www.esa.europa.eu/news-press/calendar?p_p_auth=GQqZ0Umj&p_p_id=8&p_p_lifecycle=0&p_p_state=normal&p_p_mode=view&_struts_action=%2Fcalendar%2Fview_event&_struts_eventId=1106183).

<sup>100</sup> See EMIR Proposed Margin Rules; draft amendments to the “Cabinet Office Ordinance on Financial Instruments Business” and “Comprehensive Guidelines for Supervision” with regard to margin requirements for non-centrally cleared derivatives (July 3, 2014), *available in Japanese at* <http://www.fsa.go.jp/news/26/syouken/20140703-3.html>.

<sup>101</sup> G-20 Cannes Summit Final Declaration (Nov. 2011), *available at* [https://g20.org/wp-content/uploads/2014/12/Declaration\\_eng\\_Cannes.pdf](https://g20.org/wp-content/uploads/2014/12/Declaration_eng_Cannes.pdf).