CLIENT UPDATE

BANK PRUDENTIAL REGULATORS SEEK NEW COMMENTS ON PROPOSED CAPITAL AND MARGIN RULES FOR NON-CLEARED SWAPS AND SECURITY-BASED SWAPS

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The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") required the Board of Governors of the Federal Reserve System (the "FRB"), Federal Credit Administration, Federal Deposit Insurance Corporation, the Federal Housing Finance Agency and Office of the Comptroller of the Currency (each, an "Agency," and collectively referred to as the "Agencies") to adopt rules jointly to establish capital requirements and initial and variation margin requirements with respect to all non-cleared swaps and non-cleared security-based swaps (collectively, "Covered Swaps") of certain entities registered with the Commodity Futures Trading Commission (the "CFTC") or the Securities Exchange Commission (the "SEC") for which one of the Agencies is the prudential regulator.

To comply with their mandate under the Dodd-Frank Act to adopt capital and margin rules, the Agencies released on April 12, 2011, their first proposed swap capital and margin rules (the "2011 Proposal").[1] Following the Agencies' 2011 Proposal, the Basel Committee on Banking Supervision ("BCBS") and the Board of the International Organization of Securities Commission ("IOSCO") proposed and later finalized in September 2013 an international

[1] For a discussion of the 2011 Proposal and the CFTC's proposed margin rules, please refer to our client memorandum, "Release of Proposed Rules on Swap Capital and Margin Requirements Under Title VII of the Dodd-Frank Act," dated April 28, 2011, available at: http://www.debevoise.com/newseventspubs/publications/detail.aspx?id=6b43be87-2152-475f-8bf2-563775d57e80.

framework for margin requirements on non-cleared derivatives in order to create an international standard for all non-cleared derivatives (the "2013 International Framework"). After reviewing the comments received with respect to the 2011 Proposal and the 2013 International Framework, the Agencies believe that a number of changes ought to be made to their 2011 Proposal; therefore, they have re-proposed capital and margin rules in a notice of proposed rulemaking and requested comments for the new proposed rules on September 3, 2014 (the "2014 Proposal").

Unlike the 2011 Proposal, which followed a "collection-only" approach to margin requirements, the 2014 Proposal requires Covered Swap Entities to both collect and post initial and variation margin to and from certain counterparties.

Comments are due within 60 days after the publication of the 2014 Proposal in the Federal Register.

MARGIN REQUIREMENTS

Who Is Subject to the 2014 Proposal?

The margin requirements in the 2014 Proposal, like those in the 2011 Proposal, apply only to Covered Swap Entities. A "Covered Swap Entity" is a "Swap Entity" for which one of the Agencies is the prudential regulator. "Swap Entities" include swap dealers ("SDs") and major swap participants ("MSPs") registered with the CFTC, as well as security-based swap dealers ("SBSDs") and major security-based swap participants ("MSBSPs") registered with the SEC.[2]

A Covered Swap Entity's counterparty to a Covered Swap is not directly subject to the margin requirements in the 2014 Proposal if such counterparty is not itself a Covered Swap Entity. For instance, a bank that is not required to register as an SD or SBSD, because it only engages in a *de minimis* amount of swap and security-based swap dealing activities, will not be subject to the margin requirements in the 2014 Proposal, nor will any non-bank be subject to such requirements. However, to the extent an entity enters into Covered Swaps with a Covered Swap Entity, it will be indirectly impacted by the margin requirements because the Covered Swap Entity will be required to collect margin from its counterparty in the manner prescribed in the 2014 Proposal.

[2] The Dodd-Frank Act requires (1) the CFTC to adopt capital and margin requirements for registered SDs and MSPs without prudential regulators and (2) the SEC to adopt such requirements for SBSDs and MSBSPs without prudential regulators.

Classification of Swap Counterparties

Generally

The 2014 Proposal adopts a risk-based approach to margin requirements to ensure the safety and soundness of each Covered Swap Entity, taking into account the risk posed by the Covered Swap Entity's counterparties in establishing minimum initial and variation margin amounts that a Covered Swap Entity must exchange with its counterparties. To that end, the 2014 Proposal divides a Covered Swap Entity's counterparties into the following four categories:

- Counterparties that are themselves Swap Entities,
- Counterparties that are financial end users with a material swaps exposure,
- Counterparties that are financial end users without a material swaps exposure, and
- Counterparties that are neither Swap Entities nor financial end users, including nonfinancial end users, sovereigns and multilateral development banks ("Other Counterparties").

Financial End Users

Under the 2014 Proposal, a financial end user is an entity that is not a Swap Entity and is one of a number of enumerated types of entities,[3] including bank holding companies, savings and loan holding companies, depository institutions, foreign banks, federal and state credit unions, nonbank financial institutions supervised by the FRB, commodity pools and certain private funds. The 2014 Proposal also excludes certain enumerated entities from the "financial end user" definition.

The 2014 Proposal treats financial end users with a "material swaps exposure" ("Material Financial End Users") differently from those without a material swaps exposure. A financial end user has a "material swaps exposure" if such entity and its affiliates have an average daily aggregate notional amount of Covered Swaps and foreign exchange forwards and swaps[4] with all counterparties for June, July and August of the previous

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[3] See Attachment 1 to this memorandum for a full list of the enumerated types of financial end users as well as a list of entities that are excluded from this category.

[4] A "foreign exchange forward" and a "foreign exchange swap" refer to those foreign exchange products defined in Section 1a(24) and 1a(25), respectively, of the Commodity Exchange Act, and which are those products that are excluded from the definition of "swap" by the determination of the Secretary of the Treasury. Please refer to our client memorandum, "Treasury Secretary Exempts Certain Foreign Exchange Swaps and Forwards from the Swap Definition," dated November 20, 2012, available at: http://www.debevoise.com/newseventspubs/publications/detail.aspx?id=2b8b2e69-ddd6-4731-8694-146012c12dc7.

calendar year that exceeds $3 billion, where such amount is calculated only for business days. While the 2014 Proposal imposes margin requirements only on Covered Swaps (and not on foreign exchange forwards and swaps, which the Treasury Department has exempted from the definition of "swap"), the Agencies propose that the determination of material swaps exposure also include foreign exchange forwards and swaps. Further, it is worth noting that the 2014 Proposal does not exclude inter-affiliate swaps from this calculation; therefore, it appears that a financial end user is required to count its Covered Swaps and foreign exchange forwards and swaps with all of its counterparties, including with its affiliates, towards this $3 billion threshold.

Additionally, the 2014 Proposal permits an entity that is a Material Financial End User in one year (based on its swaps exposure in June, July and August of the prior year) to re-calculate its swaps exposure in each successive year to determine whether its status has changed as the 2014 Proposal does not provide that such a designation is permanent. However, it is not clear whether Covered Swaps entered into between a Covered Swap Entity and a Material Financial End User continue to be subject to initial margin requirements even after such financial end user ceases to be a Material Financial End User, and whether initial margin exchanged by a Covered Swap Entity and a Material Financial End User can be returned once the financial end user ceases to be a Material Financial End User.

Compliance Dates and Eligible Master Netting Agreements

Compliance Dates

In general, the margin requirements in the 2014 Proposal apply only to Covered Swaps entered into by a Covered Swap Entity with certain counterparties after the relevant compliance date. However, Covered Swaps entered into prior to such compliance date will become subject to margin requirements to the extent that they are subject to a master netting agreement together with Covered Swaps entered into after the relevant compliance date.

As we describe in more detail at the end of this memorandum, the 2014 Proposal sets forth a number of different compliance dates, ranging from December 1, 2015 to December 1, 2019, by which Covered Swap Entities would be required to begin complying with the proposed margin requirements. While the compliance date for variation margin requirements is December 1, 2015 for all Covered Swaps, the compliance date for initial margin requirements varies depending on the measured swaps exposure of the Covered Swap Entity and its affiliates, on the one hand, and its counterparty and its affiliates, on the other hand. The initial margin requirements would become effective with respect to

any Covered Swap to which a Covered Swap Entity becomes a party on or after the relevant compliance date, and would continue to apply regardless of future changes in swaps exposure of the Covered Swap Entity or its counterparty.

While the margin requirements in the 2014 Proposal apply only to Covered Swaps, the applicable compliance date for initial margin requirements with respect to a particular Covered Swap is based on a Covered Swap Entity's and its counterparty's exposure arising from both Covered Swaps and foreign exchange forwards and swaps.

Eligible Master Netting Agreement

Where a Covered Swap Entity enters into swaps on or after the applicable compliance date pursuant to an "eligible master netting agreement" ("EMNA") that also governs swaps entered into prior to such compliance date, and wishes to calculate its initial and variation margin requirements on a portfolio basis and net the transactions subject to the EMNA, the margin requirements would effectively be applied retroactively to those swaps entered into prior to the applicable compliance date. If a Covered Swap Entity preferred to separate transactions entered into prior to the compliance date from those applicable to transactions entered into following such date for the purpose of margin calculations, it would need to enter into a new and separate EMNA for the post-compliance date transactions.

The 2014 Proposal defines "eligible master netting agreement"[5] as a written, legally enforceable netting agreement that (1) creates a single legal obligation for all individual transactions covered by the agreement upon an event of default (following certain permitted stays), including upon an event of receivership, insolvency, liquidation or similar proceeding, and (2) provides the Covered Swap Entity the right to accelerate, terminate and close out on a net basis all transactions under the agreement and to liquidate or apply collateral promptly upon an event of default, without being stayed or avoided under applicable law (other than certain permitted stays).[6] In order to rely on an EMNA for purposes of calculating margin on a net basis, the Covered Swap Entity must also conduct sufficient legal review to conclude with a well-founded basis that the foregoing requirements are satisfied and that, in the event of a legal challenge (including one resulting from default or insolvency), the relevant court and administrative authorities

[5] The Agencies are seeking comments on the definition of EMNA, especially on whether the proposed definition of EMNA provides sufficient clarity with respect to the laws of foreign jurisdictions that provide for limited stays.

[6] In addition, in order to qualify as an EMNA, the agreement must not contain a "walkaway clause," defined as a provision permitting a non-defaulting counterparty to make a lower payment than it otherwise would have made (or no payment at all), or suspend or condition payment, to a defaulter (or its estate), even if the defaulter is (or otherwise would be) a net creditor under the agreement.

would find the agreement to be legal, valid, binding and enforceable under the laws of the relevant jurisdictions.

General Application of Initial and Variation Margin Requirements

Before considering the particular margin requirements that apply to Covered Swap Entities transacting with each type of counterparty, we discuss certain aspects of the 2014 Proposal that generally pertain to all initial or variation margin requirements regardless of counterparty type.

Initial Margin Threshold

The 2014 Proposal permits a Covered Swap Entity to adopt a maximum initial margin threshold amount of $65 million,[7] below which it need not collect or post initial margin; however, the threshold would be applied on a consolidated basis with respect to both the Covered Swap Entity (and its affiliates) and its counterparty (and its affiliates). This threshold applies only to initial margin and not to variation margin.

As an example, the Agencies note that if a firm enters into Covered Swaps, executed under separate EMNAs, with three counterparties all belonging to the same consolidated group (such as a bank holding company), and if the initial margin requirement is $100 million for each of the firm's netting sets with each counterparty, the firm would be required to collect at least $235 million (*i.e.*, 100 + 100 + 100 – 65) from the consolidated group of the three counterparties. In that scenario, the firm could allocate the initial margin threshold to the group pursuant to an agreement among them, but could not allocate the threshold in such a way that it collects less than the $235 million.

Definition of "Affiliate"

For purposes of applying the initial margin threshold and determining the applicable compliance date for the initial margin requirements, the 2014 Proposal defines "affiliate" as any company that controls, is controlled by, or is under common control with, another company, where "control" means (1) ownership, control or power to vote 25% or more of a class of voting securities of the company, directly or indirectly or acting through one or more other persons, (2) ownership or control of 25% or more of the total equity of the company, directly or indirectly or acting through one or more other persons, or (3) control in any manner of the election of a majority of the directors or trustees of the company.

[7] The Agencies are seeking comments on whether the threshold is appropriate.

The Agencies are seeking comments on this definition of "control." Particularly, the Agencies request comments on how this definition will apply to advised and sponsored funds and sponsored securitization vehicles. Currently, the Agencies believe that under the 2014 Proposal, advised and sponsored funds and sponsored securitization vehicles would not be deemed to be affiliates of the investment adviser or sponsor unless such adviser or sponsor actually meets the requirements (*e.g.*, owning 25% or more of the voting securities or total equity or controlling the election of the majority of the directors or trustees). Further, the Agencies note that with respect to funds and sponsored vehicles, their intent is to follow the 2013 International Framework, which stated that investment funds that are managed by an investment adviser are considered distinct entities that are treated separately when applying certain margin thresholds as long as the funds are distinct legal entities that are not collateralized by or otherwise guaranteed or supported by other investment funds or the adviser in the event of fund insolvency or bankruptcy. The Agencies would like to receive comments on whether the proposed definition of "control" would allow investment funds and securitization vehicles to be treated separately in the same manner as described in the 2013 International Framework. However, as currently proposed, the definition of "control" would capture a large number of advised and sponsored funds and sponsored securitization vehicles.

Application of Minimum Transfer Amount

The 2011 Proposal included a minimum transfer amount for the collection of both initial and variation margin by Covered Swap Entities of $100,000.

The 2014 Proposal increased the minimum transfer amount to $650,000 to be consistent with the 2013 International Framework; as such, a Covered Swap Entity need not collect or post initial or variation margin from or to any single counterparty (for which such margin requirements would otherwise apply) unless and until the required cumulative amount of initial and variation margin transfer is greater than $650,000. Unlike the initial margin threshold discussed above, this minimum transfer amount applies to Covered Swaps with a single counterparty, rather than to a consolidated group of the counterparty and its affiliates.

Since this minimum transfer amount applies to both initial and variation margin, it impacts not only transactions between a Covered Swap Entity and another Swap Entity or Material Financial End User, but also transactions with a financial end user without a material swaps exposure, as the Covered Swap Entity would not be required to pay or collect variation margin to or from such counterparty until the variation margin requirement exceeds $650,000.

Counterparty Refusal

The 2011 Proposal provided that a Covered Swap Entity would not be in violation of its variation margin collection obligations where its counterparty refuses or otherwise fails to make variation margin transfers so long as the Covered Swap Entity took certain steps to attempt to collect the margin or commenced the termination of the affected Covered Swaps.

The 2014 Proposal includes similar provisions with respect to both initial and variation margin requirements. A Covered Swap Entity is not deemed to have violated its obligations when its counterparty has refused or otherwise failed to provide or accept the required margin to or from the Covered Swap Entity, if the Covered Swap Entity has (1) made the necessary efforts to collect or post the required margin, or has otherwise demonstrated upon request to the satisfaction of the appropriate Agency that it has made appropriate efforts to collect the required margin, or (2) commenced termination of the non-cleared swap with the counterparty promptly following the applicable cure period and notification requirements.

Margin Requirements for Transactions with Different Types of Counterparties

Transactions with Swap Entities

Initial Margin. Under the 2014 Proposal, a Covered Swap Entity that enters into a Covered Swap with another Swap Entity must collect initial margin for such Covered Swap in an amount that is not less than the positive difference of (1) the initial margin collection amount for the Covered Swap less (2) the initial margin threshold amount (excluding any portion of the initial margin threshold already applied by the Covered Swap Entity or its affiliates to other Covered Swaps with the counterparty or its affiliates). The other Swap Entity will also be subject to initial margin collection requirements applicable to it under either the 2014 Proposal or another regulatory regime applicable to it (*e.g.*, CFTC or SEC margin rules); therefore, with respect to Covered Swaps entered into between a Covered Swap Entity and another Swap Entity, each party will post and collect the applicable amount of initial margin to and from one another on a daily basis. The collection of initial margin must take place on a daily basis.

Variation Margin. The 2014 Proposal also requires a Covered Swap Entity that enters into a Covered Swap with another Swap Entity to post variation margin to or collect variation margin from such counterparty, as applicable, depending on the value of the Covered Swap. No margin threshold may apply to the exchange of variation margin, and it must be collected or posted (as applicable) on a daily basis.

Transactions with Financial End Users

Initial Margin. For a Covered Swap between a Covered Swap Entity and a Material Financial End User, the minimum amount of initial margin that must be collected by the Covered Swap Entity is the same as the minimum required collection amount for its transactions with another Swap Entity; in other words, for this purpose, a Material Financial End User counterparty is treated the same way as a Swap Entity counterparty. In addition, a Covered Swap Entity must post initial margin to the Material Financial End User in at least the same amount that the Covered Swap Entity would be required to collect (under the 2014 Proposal) if the Covered Swap Entity were in the place of the Material Financial End User counterparty. The posting and collection of initial margin must take place on a daily basis.

A Covered Swaps Entity transacting with a financial end user without a material swaps exposure is not subject to the minimum initial margin requirements in the 2014 Proposal, and is only required to collect the amount of initial margin that it determines to be appropriate to address the credit risk posed by such financial end user. However, as we noted earlier, it is not entirely clear whether the initial margin requirement ceases or continues once a financial end user ceases to be a Material Financial End User with respect to those Covered Swaps entered into by the financial end user when it was a Material Financial End User, and if such initial margin requirement were to cease, whether previously exchanged initial margin could be returned.

Variation Margin. The 2014 Proposal also requires a Covered Swap Entity that enters into a Covered Swap with any financial end user (whether or not a Material Financial End User) to post variation margin to or collect variation margin from such counterparty, as applicable (depending on the value of the Covered Swap). No margin threshold may apply to the exchange of variation margin, and it must be collected or posted on a daily basis.

Transactions with Other Counterparties

Under the Dodd-Frank Act, nonfinancial end users are generally exempt from mandatory clearing requirements; consequently, commenters to the 2011 Proposal argued that transactions between a Covered Swap Entity and an Other Counterparty should also be exempt from the Agencies' mandatory initial and variation margin requirements for Covered Swaps.

Instead of providing an exemption from such requirements, the 2014 Proposal requires a Covered Swap Entity to collect such initial or variation margin as it determines appropriate to address the credit risk posed by such Other Counterparty and the risks of such transactions, without setting any specific numerical requirements for initial or variation margin with respect to such transactions.

Transactions with Affiliates that are Financial End Users

The margin requirements in the 2014 Proposal generally apply to Covered Swaps between a Covered Swap Entity and any counterparty that is either a Swap Entity or a financial end user; as such, they apply to Covered Swaps between a Covered Swap Entity and its affiliates that are financial end users, including affiliates that are subsidiaries of a bank, such as operating subsidiaries, Edge Act subsidiaries, agreement corporation subsidiaries, financial subsidiaries, and lower-tier subsidiaries of such subsidiaries.[8]

Segregation of Initial Margin

The 2014 Proposal, like the 2011 Proposal, imposes margin segregation requirements on Covered Swap Entities. The segregation requirements in the 2014 Proposal apply only to initial margin, not to variation margin. However, unlike the 2011 Proposal, which imposed segregation requirements only on transactions between Covered Swap Entities, the 2014 Proposal extends these requirements to all transactions between a Covered Swap Entity and a financial end-user.

Specifically, under the 2014 Proposal, a Covered Swap Entity that posts any collateral (other than variation margin) for a Covered Swap must require its counterparty to segregate all such funds or other property at an independent third-party custodian. This applies not only to the minimum initial margin that the Covered Swap Entity is required to post under the 2014 Proposal, but also to any collateral (other than variation margin) posted as a result of negotiations between the parties that is in excess of or in addition to what is required under the 2014 Proposal (such as initial margin posted to a financial end user without a material swaps exposure or to another Covered Swap Entity where the exposure is below $65 million).

[8] The Agencies note that other applicable laws require transactions between banks and their affiliates to be on an arm's-length basis; for instance, the requirements of section 23B of the Federal Reserve Act generally would mean that a bank engaging in a swap with an affiliate should do so on the same terms (including regarding collateral posting and collection) that would otherwise apply to a swap between a bank and a non-affiliated company. However, while section 23B applies only to transactions between a bank and its financial subsidiary, the margin requirements in the 2014 Proposal apply to all Covered Swaps between a bank and any of its affiliates, including subsidiaries that are not covered by section 23B.

Additionally, under the 2014 Proposal, a Covered Swap Entity that collects initial margin amounts that are required to be collected under the 2014 Proposal for a Covered Swap must hold such initial margin at an independent, third-party custodian.[9] This requirement, unlike the corresponding requirement for margin posted by a Covered Swap Entity, applies only to the minimum initial margin that the Covered Swap Entity is required to collect under the 2014 Proposal.

The 2014 Proposal, like the 2011 Proposal, requires that the independent, third-party custodian act pursuant to a custody agreement that prohibits the custodian from rehypothecating, repledging or otherwise transferring (through securities lending, repurchase agreement, or other means) any initial margin it holds for such Covered Swap Entity pursuant to the foregoing requirements.

Despite the requirement that the custody agreement prohibit rehypothecation, the agreement may permit the posting party to substitute or direct any reinvestment of posted collateral held by the custodian so long as, with respect to the minimum initial margin that is required to be posted pursuant to the 2014 Proposal, the agreement requires the posting party to:

- Substitute only funds or other property that would qualify as eligible collateral and for which the amount (net of applicable haircuts)[10] would be sufficient to meet the initial margin posting requirements of the 2014 Proposal; and
- Direct reinvestment of funds only in assets that would qualify as eligible collateral and for which the amount (net of applicable haircuts) would be sufficient to meet the initial margin posting requirements of the 2014 Proposal.

The restrictions on the substitution of collateral described above apply only to the initial margin that is required to be posted pursuant to the 2014 Proposal and do not apply to any collateral that has been posted in excess of or in addition to the required initial margin minimum amounts.

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[9] Unlike the 2011 Proposal, the 2014 Proposal does not require that this custodian be located in a jurisdiction that applies the same insolvency regime to the custodian as would apply to the Covered Swap Entity.

[10] Appendix B to the 2014 Proposal includes a table with the applicable haircut percentages for various types of initial margin collateral. The table is attached to this memorandum as Attachment 3.

The Agencies clarify that when a Covered Swap Entity intermediates Covered Swaps between two Material Financial End Users, the 2014 Proposal would require that the Covered Swap Entity post initial margin to, and collect initial margin from, each such Material Financial End User, and that this initial margin be held at a third-party custodian that will not rehypothecate such assets.

The Agencies note that, under the 2013 International Framework, a member country may allow a swap entity to rehypothecate initial margin provided by a financial end user one time to hedge the Covered Swap Entity's exposure to the end user, provided certain safeguards protecting the end user's rights in such collateral are available under applicable law. The Agencies are seeking comment on the circumstances under which one-time rehypothecation of initial margin posted by a financial end user would be permitted under the 2013 International Framework and whether this would be a commercially viable option for market participants.

INITIAL MARGIN CALCULATION

The 2014 Proposal, like the 2011 Proposal, permits a Covered Swap Entity to select from two alternative methods to calculate its initial margin requirements on a daily basis. First, the Covered Swap Entity may calculate its initial margin using a standardized look-up table (set forth in Appendix A to the 2014 Proposal)[11] specifying the minimum initial margin requirement, expressed as a percentage of the notional amount of the Covered Swap. Alternatively, the Covered Swap Entity may calculate its minimum initial margin requirement using an internal model, so long as the internal model satisfies certain criteria[12] on an ongoing basis and is approved in advance by the relevant prudential regulator.

Under the 2011 Proposal, only an internal model could recognize portfolio effects and offsets within a portfolio of swaps with a counterparty. The standardized table in the 2011 Proposal did not recognize such portfolio effects and risk offsets. By contrast, the 2014 Proposal allows for the recognition of offsetting exposures under both approaches, as discussed below.

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[11] This standardized look-up table is attached as Attachment 2 to this memorandum.

[12] The Agencies note that the modeling standards for internal models under the 2014 Proposal are generally consistent with current regulatory rules and best practices for such models in the context of risk-based capital rules applicable to insured depository institutions and bank holding companies, are no less conservative than those generally used by central counterparties ("CCPs") for cleared derivatives and are also consistent with the standards of the 2013 International Framework.

It is worth noting that because a Covered Swap Entity is permitted to use its own internal model in determining the initial margin amount for a Covered Swap, a valuation dispute on the initial margin amount of a Covered Swap entered into between two Covered Swap Entities may occur as the parties may not be using the exact same internal model. The 2014 Proposal leaves the resolution of any such dispute to the parties. However, if there is an unresolved dispute between the two Covered Swap Entities, they may be subject to adverse consequences under the Agencies' risk-based capital rules in determining the counterparty credit mitigation impact of collateral.

Internal Models for Calculating Initial Margin

Criteria for Using Internal Model

The 2014 Proposal permits a Covered Swap Entity to use an internal model to calculate initial margin for a Covered Swap or netting set thereof covered by an EMNA, subject to the following criteria:

- The internal model must calculate an amount of initial margin that is equal to the potential future exposure of the Covered Swap or netting set thereof covered by an EMNA, consistent with a one-tailed 99% confidence interval for an increase in the value of the Covered Swap or netting set due to an instantaneous price shock that is equivalent to a movement in all material underlying risk factors (including prices, rates and spreads), over a holding period equal to the shorter of 10 business days[13] or the maturity of the Covered Swap (with the calculation performed directly over a 10-day period, with no option to indirectly compute margin by scaling a shorter horizon calculation (*e.g.*, 1 day) to be consistent with a longer horizon);
- All data used to calibrate the model must be based on an equally weighted historical observation period of at least one year and not more than five years[14] and must incorporate a period of significant financial stress for each broad asset class that is appropriate to the Covered Swaps to which the model is applied;[15]

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[13] The Agencies note that they chose a 10-day minimum close-out period, rather than the typical three to five business days used by CCPs, because non-cleared swaps are expected to be less liquid than cleared swaps. They also note that the 10-day period is consistent with counterparty credit risk capital requirements for banks.

[14] The purpose of this requirement is to balance the tradeoff between shorter and longer data spans, since longer spans are less sensitive to evolving market conditions and may place insufficient emphasis on periods of financial stress, while shorter spans may overreact to short-term, idiosyncratic spikes in volatility, yielding procyclical margin requirements.

[15] The Agencies note that the stress calibration employed for each asset class must be appropriate to the specific asset class in question, and that a common stress period calibration would be appropriate for multiple (or all) asset classes only if it is appropriate for each specific underlying asset class.

- The model must use risk factors sufficient to measure all material price risks inherent in the transactions for which initial margin is being calculated,[16] including (without limitation) foreign exchange or interest rate risk, credit risk, equity risk, agricultural commodity risk, energy commodity risk, metal commodity risk and other commodity risk, as appropriate (the "Specified Risk Categories"), plus certain additional risks for significant currencies and markets;[17]
- For option positions or positions with embedded optionality, the model must include all material risks arising from the nonlinear price characteristics of such positions and the sensitivity of the market value of such positions to changes in the volatility of the underlying rates, prices and other material risk factors;[18]
- The model must use the sum of the initial margins calculated for each broad risk category to determine the aggregate initial margin due from the counterparty;
- The model may not incorporate any proxy or approximation used to capture the risks of the Covered Swaps without the prior approval of its prudential regulator;
- The level of sophistication of the model must be commensurate with the complexity of the Covered Swaps to which it is applied;[19]

Exception for Cross-Currency Swaps

The 2014 Proposal provides an exception for non-cleared cross-currency swaps from the general requirement that an internal model must account for all material risks affecting the swap. For non-cleared cross-currency swaps, the model need not recognize any risks or risk factors associated with the fixed, physically-settled foreign exchange transactions associated with the exchange of principal embedded in the swap, but it must recognize all material risks and risk factors associated with all other payments and cash flows over the life of the swap.

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[16] A Covered Swap Entity may not omit from the calculation of its initial margin any risk factor that it uses in its internal model without the prior approval of its prudential regulator.

[17] For material exposures in significant currencies and markets, modeling techniques must capture spread and basis risk and must incorporate a sufficient number of segments of the yield curve to capture differences in volatility and imperfect correlation of rates along the yield curve.

[18] For instance, the initial margin calculation for a swap that is an option on an underlying asset, such as a credit default swap, must capture material non-linearities arising from changes in the price of the underlying asset or changes in its volatility.

[19] The model may make use of any of the generally accepted approaches for modeling the risk of a single instrument or portfolio of instruments.

The 2014 Proposal defines a "cross-currency swap" as 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 upon the inception of the swap, with a reversal of the exchange of principal at a later date fixed at the inception of the swap.

The initial margin requirements for cross-currency swaps do not apply to the portion of the swap that is the fixed exchange of principal payments. The Agencies note that the foreign exchange transactions associated with the fixed exchange of principal in a cross-currency swap are closely related to the exchange of principal that occurs in the context of a foreign exchange forward or swap, which the U.S. Treasury Department has exempted from the requirements of the Dodd-Frank Act, including the margin requirements (in part, because of the low risk profile of these transactions). Accordingly, the 2014 Proposal treats that portion of a cross-currency swap that is a fixed exchange of principals in a manner that is consistent with the treatment of foreign exchange forwards and swaps.

Non-deliverable currency forwards are not cross-currency swaps under the 2014 Proposal and thus are subject to the margin requirements in the 2014 Proposal.

Offsetting Exposures Using Internal Model

To the extent that Covered Swaps are executed pursuant to the netting arrangement under an EMNA between a Covered Swap Entity and its counterparty that is a Swap Entity or financial end user, the 2014 Proposal permits an internal model's initial margin calculation to be performed on an aggregate basis with respect to all such transactions governed by the same EMNA. Therefore, if the same EMNA governs both transactions entered into before the compliance date and transactions entered into after the compliance date, then the model must include all those transactions in the aggregate in calculating initial margin.

The 2014 Proposal permits internal models to reflect offsetting exposures, diversification and other hedging benefits for transactions covered by an EMNA by recognizing empirical correlations within each of the Specified Risk Categories, provided that the Covered Swap Entity validates and demonstrates the reasonableness of its process for modeling and measuring hedging benefits. But the 2014 Proposal does not permit internal models to reflect offsetting exposures, diversification or other hedging benefits across Specified Risk Categories.[20]

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[20] The Agencies note that the correlations of exposures across Specified Risk Categories are not stable enough over time or during periods of financial stress to be recognized for margin purposes.

As an example, the Agencies note that if a Covered Swap Entity entered into two credit swaps and two energy commodity swaps with a counterparty under an EMNA, the Covered Swap Entity could use an approved internal model to perform two separate calculations of initial margin collection amounts (*i.e.*, one for each category of swaps), with each calculation recognizing offsetting and diversification within the relevant category. The result of the two calculations would then be summed together to arrive at the total initial margin collection amount for all four swaps.

The Agencies acknowledge that some swaps may be difficult to classify into one asset class as some may have characteristics that relate to more than one class. Under the 2014 Proposal, Covered Swap Entities are encouraged to make a determination as to which asset class best represents the swap based on a holistic view of the underlying swap. For instance, many swaps may have some sensitivity to interest rates even though the majority of the swap's sensitivity relates to another assets class, such as equity or credit.[21]

If the model does not explicitly reflect offsetting exposures, diversification and hedging benefits between subsets of Covered Swaps within a Specified Risk Category, the Covered Swap Entity must calculate an amount of initial margin separately for each subset of Covered Swaps for which offsetting exposures, diversification and other hedging benefits are explicitly recognized by the model. The sum of the initial margin amounts calculated for each such subset will be used to determine the aggregate initial margin due from the counterparty for the portfolio of Covered Swaps within the Specified Risk Category.

The model may not permit the calculation of any initial margin collection amount of the Covered Swap Entity to be offset by, or otherwise take into account, any initial margin that may be owed or otherwise payable by the Covered Swap Entity to its counterparty. In other words, the parties may not offset their initial margin posting and collection amounts from each other.

Periodic Review of Internal Model by Covered Swap Entity and Documentation Requirement

In addition to the foregoing requirements, the 2014 Proposal requires a Covered Swap Entity that uses an internal model to have a rigorous and well-defined process for re-estimating, re-evaluating and updating its model to ensure continued applicability and relevance, and requires the Covered Swap Entity to review and, as necessary, revise the data used to calibrate the model at least monthly (and more frequently as market

[21] The Agencies are seeking comments on material instances in which the classification of a swap into one asset class is problematic, and if so, on alternative approaches to dealing with such swaps (such as identifying an additional asset class of "unclassified swaps" that would be margined separately from all other swaps).

conditions warrant), to ensure that the data incorporate a period of significant financial stress appropriate to the transactions to which the model is applied.

The 2014 Proposal requires a Covered Swap Entity to maintain a risk control unit that reports directly to senior management and is independent from the business trading units. The risk control unit is required to validate its model prior to implementation and on an ongoing basis, and this validation process must either be independent of the development, implementation and operation of the model or be subject to an independent review of its adequacy and effectiveness. The validation process must also include:

- An evaluation of the conceptual soundness of the model (including supporting developmental evidence);
- An ongoing monitoring process that includes verification of processes and benchmarking by comparing the model's outputs (estimates of initial margin) with relevant alternative internal and external data sources or estimation techniques, including benchmarking against observable margin standards to ensure that the initial margin required is not less than what a CCP (specifically, a derivatives clearing organization or clearing agency)[22] would require for similar cleared transactions;[23] and
- An outcomes analysis process that includes backtesting the model.

If the validation process reveals any material problems with the model, the 2014 Proposal requires the Covered Swap Entity to notify its prudential regulator of the problems, describe any remedial actions being taken and adjust the model to ensure an appropriately conservative amount of initial margin is being calculated.

Additionally, the 2014 Proposal requires a Covered Swap Entity to review its internal model at least annually in light of developments in financial markets and modeling technologies and enhance the model as appropriate to ensure that it continues to meet the foregoing requirements. Specifically, a Covered Swap Entity must have an internal audit function independent of business-line management and the risk control unit that at least annually (1) assesses the effectiveness of the controls supporting the model's measurement systems (including the activities of the business trading units and risk control unit,

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22 A "derivatives clearing organization" ("DCO") is a CCP for swaps, registered with the CFTC under section 5b of the CEA. A "clearing agency" is a CCP for security-based swaps, registered with the SEC under section 17A(g) of the Securities Exchange Act.

23 The Agencies note that, in addition to providing a "readily observable minimum" for initial margin, benchmarking will limit the extent to which the use of internal models might disadvantage the movement of certain swaps to CCPs (by setting lower initial margin amounts for non-cleared transactions than for similar cleared transactions).

compliance with policies and procedures and calculation of initial margin requirements), and (2) reports its findings to the board of directors or a committee thereof.

The 2014 Proposal requires a Covered Swap Entity to document all material aspects of its internal model, including the management and valuation of the Covered Swaps to which the model applies, the control, oversight and validation of the model, any review processes and the results of such processes.

Review by Prudential Regulator

Under the 2014 Proposal, the appropriate prudential regulator would review a Covered Swap Entity's internal model for approval upon the request of the Covered Swap Entity. Models that are reviewed for approval would be analyzed and subjected to certain tests to ensure compliance with the 2014 Proposal.[24]

If the relevant prudential regulator determines, in its sole discretion, that an internal model no longer complies with the above criteria, it may rescind its approval of the model, in whole or in part, or may impose additional conditions or requirements. In addition, the relevant prudential regulator may, in its sole discretion, require a Covered Swap Entity to collect a greater amount of initial margin than that determined by its internal model if the regulator determines that the additional collateral is appropriate due to the nature, structure or characteristics of the relevant transactions, or is commensurate with the risks associated with the transactions.

Extending an Internal Model to Additional Products and other Material Changes to Model

For internal models that have been approved by the relevant prudential regulator, the 2014 Proposal requires a Covered Swap Entity to notify the regulator in writing 60 days prior to:

- Extending the use of the model to an additional product type;
- Making any change to the model that would result in a material change in the Covered Swap Entity's assessment of initial margin requirements; or
- Making any material change to modeling assumptions used by the model.

[24] The Agencies note that, since they expect specific internal models will vary across Covered Swap Entities (based on their "highly specialized business lines"), the specific analyses that will be undertaken in the context of any single review will be tailored to the intended uses of the model. The Agencies further note that they expect the nature and scope of these reviews to be similar to those conducted in the context of other model review processes (such as for regulatory capital purposes).

A Covered Swap Entity is required to adequately document internal authorization procedures, including escalation procedures, that require review and approval of any change to the initial margin calculation under the model, demonstrable analysis that any basis for any such change is consistent with the requirements of the 2014 Proposal and independent review of such analysis and approval.

Standardized Initial Margin Calculation

Covered Swap Entities that are unable or unwilling to make the technology and related infrastructure investments necessary to satisfy the foregoing criteria must calculate their initial margin using the standardized look-up table. The standardized initial margins in the table depend on the asset class, and in the case of the credit and interest rate asset classes, the duration of the underlying non-cleared swap. As in the case of internal-model-generated initial margins, the standardized initial margin calculation must also be performed on a daily basis.

While there is somewhat less scope under the standardized calculation for the initial margin collection amounts to vary on a daily basis (since the calculation is based on the standardized look-up table), certain factors may result in daily changes in the initial margin collection amount under the standardized calculation, such as: (1) a change to the notional size of the portfolio arising from any addition or deletion of swaps; (2) changes in the "NGR" or "net-to-gross ratio" resulting from changes in the valuation of the underlying swap; or (3) changes to characteristics of a swap that determine the gross initial margin (in the look-up table), such as a decline in an interest rate swap's duration from above two years to below two years (resulting in a decline in the gross initial margin applied from 2% to 1%).

Unlike the standardized table in the 2011 Proposal, the standardized calculation in the 2014 Proposal allows for the recognition of risk offsets/offsetting exposures through the use of a "net-to-gross ratio" in cases where a portfolio of Covered Swaps is governed by an EMNA. Under the standardized calculation, the initial margin amount for multiple Covered Swaps subject to an EMNA is calculated using the formula:

Initial Margin = (0.4 x Gross Initial Margin) + (0.6 x NGR x Gross Initial Margin), where:

- "Gross Initial Margin" is the sum of (1) the notional value of each Covered Swap multiplied by (2) the appropriate (gross) initial margin requirement percentage (from the look-up table) for each non-cleared swap subject to the EMNA; and

- "NGR" (the "net-to-gross ratio") is the ratio of the net current replacement cost to the gross current replacement cost, where the "gross current replacement cost" is the sum of the replacement costs (if positive) for each transaction subject to the EMNA, and the "net current replacement cost" is the total replacement cost for all such transactions.[25]

The Agencies note that the purpose of the "0.4 x Gross Initial Margin" in the foregoing formula is to limit the benefits of the NGR calculation by introducing a standardized initial margin term that is independent of NGR.

With respect to cross-currency swaps, the 2014 Proposal sets the gross initial margin rates for the standardized approach equal to those for interest rate swaps, recognizing that cross-currency swaps are subject to risks arising from fluctuations in interest rates, without recognizing any risks associated with the fixed exchange of principal (since principal is typically not exchanged on interest rate swaps).

As an example of the NGR, the Agencies note that a portfolio with two non-cleared swaps under an EMNA in which the mark-to-market value of the first is $10 (in favor of the Covered Swap Entity), while that of the second is -$5 (in favor of its counterparty) would yield a net current replacement cost of $5, a gross current replacement cost of $10 and an NGR of 0.5 (*i.e.*, 5 divided by 10).

As an example of the standardized initial margin calculation, the Agencies note that if both of these swaps have a notional value of $100 and the swap with the mark-to-market value of $10 is a sold 5-year credit default swap, while the swap with the -$5 value is an equity swap, the standardized initial margin requirement would be:

$$[0.4 \times (100 \times 0.05 + 100 \times 0.15) + 0.6 \times 0.5 \times (100 \times 0.05 + 100 \times 0.15)] = 8 + 6 = 14$$

The NGR calculation is applied only to swaps subject to the same EMNA.[26] However, unlike the internal model approach (which allows netting only within each asset class), the standardized calculation of NGR is performed across transactions in disparate asset classes that are all governed by a single EMNA (consistent with the standardized counterparty credit risk capital requirements).

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25 Since at the time a non-cleared swap is entered into, its net and gross current replacement costs are often both zero (thereby precluding the NGR calculation, in cases where a new swap is added to an existing portfolio that is being executed under an existing EMNA, the NGR may be calculated with respect to the existing portfolio of swaps. Where an entirely new swap portfolio is being established, the initial value of the NGR should be set to 1.0 and recalculated only after the first day's mark-to-market valuation has been recorded for the portfolio.

26 Where a party maintains multiple swap portfolios under multiple EMNAs, the standardized initial margin amounts would be calculated separately for each portfolio with each calculation using the gross initial margin and NGR relevant to the portfolio (and would then be added together to arrive at the total standardized initial margin).

The Agencies note that BCBS has recently adopted a new method for capitalizing counterparty credit risk (the "standardised approach for measuring counterparty credit risk" or "SA-CCR"),[27] which may also be appropriate for recognizing risk offsets in a standardized margin context; while the 2014 Proposal adopts the NGR approach described above, the Agencies are seeking comment on whether the SA-CCR approach would be a better method.

Combined Use of Internal Models and Standardized Approaches

The Agencies acknowledge that, as discussed in the 2013 International Framework, it is appropriate under certain circumstances for a Covered Swap Entity to employ both internal model-based and standardized approaches for calculating initial margins. However, the Agencies stress that it would not be appropriate for a Covered Swap Entity to cherry pick by choosing whichever approach produces the lowest margin requirement (based on differences between the two approaches across different types of swaps); rather, the choice of which method to use should be based on fundamental considerations apart from which produces the more favorable result. Furthermore, since the Agencies do not anticipate a need for Covered Swap Entities to switch between the two approaches for a particular counterparty, absent a significant change in the nature of the entity's swap activities, a Covered Swap Entity must provide a rationale for changing methodologies if so requested by its prudential regulator.

VARIATION MARGIN CALCULATION

The 2014 Proposal generally requires Covered Swap Entities transacting with other Swap Entities or with financial end users to collect and pay daily variation margin on a Covered Swap in an amount that is at least equal to the increase or decrease (as applicable) in the mark-to-market value (to the Covered Swap Entity) of the transaction since the previous exchange of variation margin.

Additionally, the 2014 Proposal, like the 2011 Proposal, permits a Covered Swap Entity to calculate variation margin requirements on an aggregate net basis across all Covered Swaps with a counterparty that are executed under a single EMNA. As stated earlier, if an EMNA governs both transactions entered into before and after the applicable compliance date, all those transactions must be included in the aggregate for purposes of calculating the variation margin requirement.

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[27] BCBS, "The Standardised Approach for Measuring Counterparty Credit Risk Exposures" (March 2014, rev. Apr. 2014), *available at*: http://www.bis.org/press/p140331.htm.

ELIGIBLE COLLATERAL

The 2014 Proposal expands on the 2011 Proposal's list of eligible collateral that may be used to meet minimum[28] initial margin requirements, but narrows the list of eligible collateral that may be used to meet the minimum variation margin requirements.

Under the 2011 Proposal, both initial and variation margin requirements could be met with immediately available cash (denominated either in U.S. dollars or in the currency in which the swap is to be settled) and obligations issued by or fully guaranteed by the U.S. government. With respect to initial margin only, eligible collateral under the 2011 Proposal also included senior debt obligations issued by certain U.S. Government-sponsored-enterprises ("GSEs").

The 2014 Proposal narrows the list of eligible collateral that may be collected or posted to meet minimum variation margin requirements to include only immediately available cash (denominated either in U.S. dollars or in the currency in which the swap is to be settled).[29] The value of cash paid to satisfy variation margin requirements is not subject to haircut under the 2014 Proposal.

The 2014 Proposal expands the list of eligible collateral that may be used to satisfy minimum initial margin requirements. Eligible collateral for these purposes includes cash collateral (subject to the same requirements applicable to variation margin), gold and any of the following:[30]

- a security issued by, or unconditionally guaranteed by, the U.S. Treasury Department;
- a security issued by, or unconditionally guaranteed by, a U.S. government agency (other than the Treasury Department) whose obligations are fully guaranteed by the U.S. government;

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[28] The standards for eligible initial margin collateral pertain only to collateral used to meet the minimum requirements in the 2014 Proposal, and do not restrict the types of collateral that may be used to satisfy bilaterally negotiated margin terms (that are not required by the 2014 Proposal). Similarly, since the 2014 Proposal requires Covered Swap Entities to collect initial margin for Covered Swaps with Other Counterparties in such forms and amounts (if any), and at such times that the Covered Swap Entity determines appropriate, the Covered Swap Entity may choose to collect any form of collateral it desires from such a counterparty to meet its initial margin collection requirement (including in forms other than those specified in the 2014 Proposal as eligible collateral).

[29] The Agencies note that, in determining the currency in which a swap is required to be settled, a Covered Swap Entity must consider the entirety of the contractual obligation. For instance, where a number of swaps, each potentially denominated in a different currency, are subject to a single master agreement requiring all swap cash flows to be settled in a single currency, then that currency may be considered the settlement currency.

[30] The Agencies note that counterparties that wish to rely on assets that do not qualify as eligible collateral may still pledge those assets with a lender in a separate arrangement, using the cash or other eligible collateral received from that separate arrangement to meet the minimum margin requirements.

- a publicly traded debt security issued by, or an asset-backed security fully guaranteed by, a GSE that is operating with capital support or other direct financial assistance received from the U.S. government that enables the repayments of the GSE's eligible securities;
- any major currency, regardless of whether it is the currency in which the swap is to be settled;
- a security issued by or fully guaranteed by the European Central Bank or a sovereign entity that is assigned no higher than a 20% risk weight under the federal banking agencies' risk-based capital rules applicable to the Covered Swap Entity;[31]
- a security issued by or unconditionally guaranteed by the Bank for International Settlements, the International Monetary Fund or a multilateral development bank;
- a publicly traded debt security (other than an asset-backed security) for which the issuer has adequate capacity to meet financial commitments (as defined by the appropriate federal agency), including such a security issued by a GSE; and
- a publicly traded common equity security included in the S&P Composite 1500 Index, an index that a Covered Swap Entity's foreign supervisor recognizes for the purposes of including publicly traded common equity as initial margin under applicable regulatory policy (if held in that foreign jurisdiction), or any other index representing equities that are as liquid and readily marketable as those included in the S&P Composite 1500 Index (as determined by the prudential regulator).

With respect to corporate securities, the 2014 Proposal further restricts eligible initial margin collateral to exclude any corporate securities (equity or debt) issued by the counterparty or any of its affiliates, a bank holding company, a savings and loan holding company, a foreign bank, a depository institution, a market intermediary or any company that would be one of the foregoing if it were organized under the laws of the United States or any state thereof, or an affiliate of one of the foregoing.

The recognized value of such initial margin collateral is subject to certain haircuts described in Appendix B to the 2014 Proposal (see Attachment 3 to this memorandum).

The 2014 Proposal requires a Covered Swap Entity to monitor the market value and eligibility of all collateral collected and held to satisfy its initial margin requirements and, where the market value of such collateral declines, to promptly collect such additional eligible collateral as is necessary to bring itself into compliance with the margin requirements on a daily basis.

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[31] *See* 12 CFR part 3, subpart D, 12 CFR part 217, subpart D, and 12 CFR part 324, subpart D.

TRADE DOCUMENTATION

The 2014 Proposal retains most of the trade documentation requirements substantially as proposed in the 2011 Proposal, except that the requirements in the 2014 Proposal apply only to transactions with Swap Entities or financial end-users.[32] The 2014 Proposal requires Covered Swap Entities to execute trading documentation with each such counterparty regarding credit support arrangements. The documentation must:

- Provide both counterparties with the contractual right to collect and post initial and variation margin in the form and amounts required by the 2014 Proposal;
- Specify the methods, procedures, rules, and inputs for determining the value of each Covered Swap for purposes of calculating variation margin requirements; and
- Specify the procedures by which any disputes concerning the valuation of such Covered Swaps, or the valuation of assets collected or posted as initial or variation margin, may be resolved.

To avoid duplicative requirements, the Agencies are requesting comments on whether compliance with the applicable CFTC or SEC swap trading documentation requirements (applicable to Swap Entities)[33] should be deemed to constitute compliance with the 2014 Proposal's documentation requirements.

CROSS-BORDER APPLICATION

The 2014 Proposal, like the 2011 Proposal, provides a limited exception for foreign swaps and security-based swaps of a foreign entity. More specifically, the extraterritorial application of the 2014 Proposal, like that of the 2011 Proposal, can be divided into three groups of transactions:

- U.S. Covered Swap Entities transacting with a foreign counterparty;
- Foreign Covered Swap Entities transacting with a foreign counterparty (without any guaranty from a U.S. entity or an entity controlled by a U.S. entity); and
- Foreign Covered Swap Entities transacting with a U.S. counterparty (or with a foreign counterparty, where one party is guaranteed by a U.S. entity or an entity controlled by a U.S. entity).

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[32] The trade documentation requirements in the 2011 Proposal applied to transactions with all counterparties, including non-financial end users.

[33] For CFTC final rules, see Part 23, subpart I of the CFTC regulations; see also 77 Fed. Reg. 55903 (Sep. 11, 2012). For SEC proposed rules, 76 Fed. Reg. 3859 (Jan. 21, 2011); see also 78 Fed. Reg. 30800 (May 23, 2013) (reopening of comment period).

U.S. Covered Swap Entities Transacting with Foreign Counterparties

The 2014 Proposal requires U.S. Covered Swap Entities to collect margin from, and post margin to, their foreign counterparties in line with the amounts collected and posted to U.S. counterparties, without regard to the counterparty's domicile. The only exception is that a U.S. Covered Swap Entity, for purposes of its margin posting obligation, may rely on a substituted compliance determination obtained by its foreign counterparty with respect to the counterparty's margin collection requirement (unless otherwise stated in the substituted compliance determination).

Foreign Covered Swap Entities Transacting with Foreign Counterparties with No Guarantee

The 2014 Proposal, like the 2011 Proposal, establishes a limited exception to its reach for those swap activities that are significantly outside of the direct interests of any U.S.-based entity. Specifically, under the 2014 Proposal, the margin requirements would not apply to any "foreign non-cleared swap or foreign non-cleared security-based swap" (a "foreign Covered Swap") of a foreign Covered Swap Entity. A "foreign Covered Swap" is any Covered Swap with respect to which neither the counterparty nor any guarantor of either party's obligations is (1) an entity organized under the laws of the United States or any state thereof (including a U.S. branch, agency or subsidiary of a foreign bank), (2) a branch or office of an entity organized under the laws of the United States or any state thereof, or (3) a Covered Swap Entity that is controlled, directly or indirectly, by an entity that is organized under the laws of the United States or any state thereof.

Similarly, a "foreign Covered Swap Entity" is a Covered Swap Entity that is not (1) an entity organized under the laws of the United States or any state thereof (including a U.S. branch, agency or subsidiary of a foreign bank), (2) a branch or office of an entity organized under the laws of the United States or any state thereof, or (3) an entity controlled, directly or indirectly, by an entity that is organized under the laws of the United States or any state thereof.

Thus, a Covered Swap Entity's swap activity would be exempt from the proposed margin requirements only if the Covered Swap Entity is located outside of the United States and organized under foreign law, and its counterparty is not a U.S.-organized-or-domiciled entity or controlled by a U.S.-organized-or-domiciled entity and the transaction is not guaranteed by a U.S. person. For instance, the exemption would apply where a European-based and European-organized SD engages in swap transactions with an Asian-based and

Asian-organized counterparty, where neither entity is controlled by a U.S. company and the transaction is not guaranteed by a U.S. person.[34]

Foreign Covered Swap Entities Transacting with U.S. Counterparties and Transactions Subject to U.S. Guarantees

The foregoing exemption is not available for a foreign Covered Swap Entity's transactions (1) with U.S. counterparties or (2) with foreign counterparties, where one of the parties is guaranteed by a U.S. person.

However, in certain circumstances, substituted compliance may be available, whereby the Covered Swap Entity may satisfy its requirements under the 2014 Proposal by complying with the foreign regulatory framework for Covered Swaps, which the prudential regulators jointly (conditionally or unconditionally) determined by public order as satisfying the corresponding requirements of the 2014 Proposal. Moreover, under the 2014 Proposal, where a Covered Swap Entity's foreign counterparty is subject to a foreign regulatory framework for which substituted compliance is permitted, unless otherwise stated in that substituted compliance determination, a Covered Swap Entity may satisfy its initial margin posting requirement by posting initial margin in the form and amount, and at such times, that its counterparty is required to collect margin pursuant to the foreign regulatory framework.

Under the 2014 Proposal, a Covered Swap Entity may rely on a substituted compliance determination only if:

- its obligations under the Covered Swap are not guaranteed by an entity organized under the laws of the United States or any state thereof; and
- the Covered Swap Entity is (1) a foreign Covered Swap Entity, (2) a foreign bank or a U.S. branch or agency of a foreign bank, or (3) a foreign subsidiary of a depository institution, Edge corporation or agreement corporation.

[34] Additionally, since the Dodd-Frank Act requires *registered* SDs and SBSDs for which one of the Agencies is the prudential regulator (for purposes of Title VII) to comply with that Agency's margin rule for non-cleared swaps, and since the CFTC and the SEC have adopted interpretive guidance and final rules clarifying that foreign subsidiaries of U.S. firms engaging in swaps activities abroad are not required to register with the CFTC or SEC *solely* on account of their parent's presence in the United States, the Agencies note that there may be circumstances in which, for instance, a foreign subsidiary of a U.S. insured depository institution, including foreign subsidiaries of Edge Act corporations, may engage in non-cleared swaps activities abroad without having to register with the CFTC or SEC, and thus without being covered by the margin rules in the 2014 Proposal.

Where these requirements are met, a Covered Swap Entity may request a substituted compliance determination with respect to its Covered Swap activities provided such activities are directly supervised by the authorities administering the relevant foreign regulatory framework. The request must include a description of:

- the scope and objectives of the foreign regulatory framework,
- the specific provisions of the foreign regulatory framework that govern (1) the scope of transactions covered, (2) the determination of required initial and variation margin amounts and the calculations used, (3) the timing of margin requirements, (4) any documentation requirements, (5) the forms of eligible collateral, (6) any segregation and rehypothecation requirements, and (7) the approval process and standards for models used in calculating initial and variation margin;
- the supervisory compliance program and enforcement authority exercised by the foreign financial regulatory authority (or authorities) to support its oversight of the application of this regulatory framework and how that framework applies to the Covered Swap Entity's Covered Swaps; and
- any other descriptions and documentation the prudential regulators determine appropriate.

In determining whether to permit substituted compliance with respect to a particular foreign regulatory framework, the prudential regulators will consider whether the corresponding requirements of that foreign regulatory framework are comparable to the otherwise applicable requirements of the 2014 Proposal and are appropriate for the safe and sound operation of the Covered Swap Entity. The Agencies will jointly make a comparability determination, taking a holistic view focusing on the outcomes produced by the entire foreign framework (*e.g.*, margin posting requirements, collection requirements, model requirements, eligible collateral and segregation requirements), as compared to the U.S. framework. The Agencies would consider factors such as the scope, objectives and specific provisions of the foreign framework and the effectiveness of the supervisory compliance program administered, and the enforcement authority exercised, by the relevant foreign regulatory authorities.

While the Agencies would accept a request from a Covered Swap Entity for a determination that it be allowed to comply with a foreign regulatory framework if a favorable comparability determination were made with respect to the foreign framework, once the Agencies make a favorable comparability determination for a foreign regulatory framework, any Covered Swap Entity could comply with the foreign framework (to satisfy its obligations under the 2014 Proposal) without making a specific request.

COMPLIANCE DATES

Covered Swap Entities must comply with the margin requirements on or before the following dates with respect to Covered Swaps entered into on or after the following dates:

- December 1, 2015, with respect to the variation margin requirements for Covered Swaps;
- December 1, 2015, with respect to the requirements for initial margin where both (1) the Covered Swap Entity combined with all its affiliates, and (2) the counterparty combined with all its affiliates, have an average daily aggregate notional amount of Covered Swaps and foreign exchange forwards and swaps for June, July and August 2015 that exceeds $4 trillion, where such amounts are calculated only for business days;
- December 1, 2016, with respect to initial margin where both (1) the Covered Swap Entity combined with all its affiliates, and (2) the counterparty combined with all its affiliates, have an average daily aggregate notional amount of Covered Swaps and foreign exchange forwards and swaps for June, July and August 2016 that exceeds $3 trillion, where such amounts are calculated only for business days;
- December 1, 2017, with respect to initial margin where both (1) the Covered Swap Entity combined with all its affiliates, and (2) the counterparty combined with all its affiliates, have an average daily aggregate notional amount of Covered Swaps and foreign exchange forwards and swaps for June, July and August 2017 that exceeds $2 trillion, where such amounts are calculated only for business days;
- December 1, 2018, with respect to initial margin where both (1) the Covered Swap Entity combined with all its affiliates, and (2) the counterparty combined with all its affiliates, have an average daily aggregate notional amount of Covered Swaps and foreign exchange forwards and swaps for June, July and August 2018 that exceeds $1 trillion, where such amounts are calculated only for business days; and
- December 1, 2019, with respect to initial margin for any Covered Swap Entity with respect to Covered Swaps entered into with any other counterparty.

Once a Covered Swap Entity and its counterparty become subject to compliance with the initial margin requirement based on the foregoing timeline, both the Covered Swap Entity and its counterparty will remain subject to the initial margin requirement regardless of their subsequent derivatives activities.

CAPITAL REQUIREMENTS

With respect to capital requirements, the 2014 Proposal, like the 2011 Proposal, only requires a Covered Swap Entity to comply with the risk-based and leverage capital requirements already applicable to it as part of its prudential regulatory regime, and does not impose any additional capital requirements under the Agencies' Title VII rulemaking authority.

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Please do not hesitate to contact us with any questions.

September 15, 2014

Attachment I

I. List of Financial End Users:

Under the 2014 Proposal, an entity that is not a Swap Entity is a financial end-user if it is:

- a bank holding company or an affiliate thereof, a savings and loan holding company, or a nonbank financial institution supervised by the FRB under Title I of the Dodd-Frank Act;
- a depository institution, a foreign bank, a federal credit union or state credit union, as defined in section 2 of the Federal Credit Union Act, an institution that functions solely in a trust of fiduciary capacity as described in section 2(c)(2)(D) of the Bank Holding Company Act, an industrial loan company, an industrial bank, or other similar institution described in section 2(c)(2)(H) of the Bank Holding Company Act;
- an entity that is state-licensed or registered as: (A) a credit or lending entity, including a finance company, money lender, installment lender, consumer lender or lending company, mortgage lender, broker, or bank, motor vehicle title pledge lender, payday or deferred deposit lender, premium finance company, commercial finance or lending company, or commercial mortgage company, except entities registered or licensed solely on account of financing the entity's direct sales of goods or services to customers; or (B) a money services business, including a check casher, money transmitter, currency dealer or exchange, or money order or traveler's check issuer;
- a regulated entity as defined in section 1303(20) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 and any entity for which the Federal Housing Finance Agency or its successor is the primary federal regulator;
- any institution chartered and regulated by the Farm Credit Administration in accordance with the Farm Credit Act of 1971;
- a securities holding company, a broker or dealer, an investment adviser as defined in section 202(a) of the Investment Advisers Act of 1940 (the "Investment Advisers Act"), and investment company registered with the SEC under the Investment Company Act of 1940 (the "Investment Company Act"), or a company that has elected to be regulated as a business development company pursuant to section 54(a) of the Investment Company Act;
- a private fund as defined in section 202(a) of the Investment Advisers Act, an entity that would be an investment company under section 3 of the Investment Company Act but for section 3(c)(5)(C), or an entity that is deemed not to be an investment company under section 3 of the Investment Company Act pursuant to Rule 3a-7;

- a commodity pool, a commodity pool operator, or a commodity trading advisor as defined, respectively, in sections 1(a)(10), 1(a)(11) and 1(a)(12) of the Commodity Exchange Act, or a futures commission merchant;
- an employee benefit plan as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income and Security Act of 1974;
- an entity that is organized as an insurance company, primarily engaged in writing insurance or reinsuring risks underwritten by insurance companies, or is subject to supervision as such by a state insurance regulator or foreign insurance regulator;
- an entity that is, or holds itself out as being, an entity or arrangement that raises money from investors primarily for the purposes of investing in loans, securities, swaps, funds, or other assets for resale or other disposition or otherwise trading in loans, securities, swaps, funds or other assets;
- an entity that would be a financial end user described in the 2014 Proposal, if it were organized under the laws of the United States or any state thereof; or
- any other person as may designated by one of the Agencies.

II. Entities Excluded from Financial End User Definition

The 2014 Proposal excludes the following entities from the definition of "financial end user":

- a sovereign entity,
- a multilateral development bank,
- The Bank for International Settlements,
- an entity that is exempt from the definition of financial entity pursuant to section 2(h)(7)(C)(iii) of the Commodity Exchange Act and implementing regulations, and
- an affiliate that qualifies for the exemption from clearing pursuant to section 2(h)(7)(D) of the Commodity Exchange Act or section 3C(g)(4) of the Securities Exchange Act, and their respective implementing regulations.

Attachment 2

Standardized Minimum Gross Initial Margin Requirements

Asset Class	**Gross Initial Margin (% of Notional Exposure)**
Credit: 0-2 year duration	2
Credit: 2-5 year duration	5
Credit: 5+ year duration	10
Commodity	15
Equity	15
Foreign Exchange/Currency	6
Cross-Currency Swaps: 0-2 year duration	1
Cross-Currency Swaps: 2-5 year duration	2
Cross-Currency Swaps: 5+ year duration	4
Interest Rate: 0-2 year duration	1
Interest Rate: 2-5 year duration	2
Interest Rate: 5+ year duration	4
Other	15

Attachment 3

<u>Margin Values for Cash and Noncash Initial Margin Collateral</u>

Asset Class		Haircut ("H") (% of Market Value)
Cash in same currency as swap obligation		0.0
Eligible government and related (*e.g.*, central bank, multilateral development bank, securities of a GSE operating with capital support or direct financial assistance from the U.S. government)	Residual maturity < 1 yr	0.5
	Residual maturity = 1 - 5 yrs	2.0
	Residual maturity > 5 yrs	4.0
Eligible corporate debt (including other eligible GSE debt securities)	Residual maturity < 1 yr	1.0
	Residual maturity = 1-5 yrs	4.0
	Residual maturity > 5 yrs	8.0
Equities included in S&P 500 or related index		15
Equities included in S&P 1500 Composite or related index but not S&P 500 or related index		25.0
Gold		15.0
Additional (additive) haircut on asset in which the currency of the swap obligation differs from that of the collateral asset		8.0

The value of initial margin collateral for any collateral asset class (calculated using this <u>Attachment 3</u>) will be calculated as:

(Total value of collateral in any asset class) x (1 – H), where "H" is the applicable haircut percentage in the above table.