

Derivatives Alert

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CFTC Proposes Rules for Cross-Border Application of Uncleared Margin

The Commodity Futures Trading Commission (CFTC) recently proposed rules¹ to address the cross-border application of margin requirements for uncleared swaps for swap dealers and major swap participants not subject to regulation by U.S. banking regulators (collectively “covered swap entities” or CSEs).²

In 2014, U.S. banking regulators (Prudential Regulators) and the CFTC each re-proposed rules that would impose margin requirements for uncleared swaps.³ In the cross-border context, the Prudential Regulators’ proposal would allow swap entities operating in a foreign jurisdiction or organized as foreign branches of U.S. banks to rely on substituted compliance with a foreign regulatory framework for uncleared swaps margin if the Prudential Regulators jointly determine that such foreign margin requirements are comparable to the requirements of the Prudential Regulators’ uncleared margin rules.

As to the CFTC, prior to issuing its uncleared margin re-proposal, the CFTC issued cross-border interpretive guidance that addressed many transaction and entity-level requirements but was silent on uncleared margin.⁴ The CFTC took a more circumspect approach in its 2014 re-proposal by including an Advance Notice of Proposed Rulemaking (ANPR) requesting comment on three alternative approaches to applying uncleared margin requirements to cross-border transactions.⁵ The CFTC is now proposing a hybrid approach to its three proposed alternatives that would allow substituted compliance for a CSE depending on whether the CSE is a U.S. person or a non-U.S. person as defined in the CFTC’s proposed rules.

For U.S. CSEs (including non-U.S. CSEs whose swap obligations are guaranteed by a U.S. person), the CFTC would permit substituted compliance for posting uncleared initial margin to (but not collecting uncleared margin from) any non-U.S. counterparty

¹ A copy of the proposed rules is available on the CFTC’s website: <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister062915.pdf>.

² Swap entities that have a Prudential Regulator will be subject to margin requirements imposed by the relevant U.S. banking regulator rather than the CFTC’s margin requirements for uncleared swaps.

³ See Skadden’s September 19, 2014, client alert, “Prudential Regulators and CFTC Re-Propose Margin Requirements for Non-Cleared Swaps,” available at http://www.skadden.com/sites/default/files/publications/Prudential_Regulators_and_CFTC_Re-Propose_Margin_Requirements_for_Non-Cleared_Swaps.pdf.

⁴ See Skadden’s July 31, 2013, client alert, “CFTC Issues Final Guidance and Accompanying Exemptive Order on Cross-Border Application of Certain Swap Regulations,” available at http://www.skadden.com/sites/default/files/publications/CFTC_Issues_Final_Cross_Border_Guidance_and_Accompanying_Exemptive_Order.pdf.

⁵ The potential approaches were i) a transaction-level approach consistent with the CFTC’s July 2013 cross-border guidance, ii) an approach consistent with the Prudential Regulators’ approach, and iii) an entity-level approach.

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whose uncleared swap obligations are not guaranteed by a U.S. person, provided that the CFTC determines that the non-U.S. CSE is subject to comparable margin requirements in its home jurisdiction. The proposed rules provide a standard of review for any CFTC comparability determination, which the CFTC describes as an “outcome-based” approach that evaluates the comparability of end results on an element-by-element basis. For example, the CFTC could determine that a jurisdiction’s initial margin calculation requirements are comparable, but the jurisdiction’s collateral standards are not, and thus only allow substituted compliance for the former but not the latter.

For non-U.S. CSEs whose swap obligations are not guaranteed by a U.S. person, substituted compliance as described above generally would be available as well for swaps with certain other entities including U.S. persons who are not CSEs. In addition, the CFTC has proposed an outright exclusion from its uncleared margin requirements for any uncleared swap entered into between a non-U.S. CSE and any other non-U.S. person (including another non-U.S. CSE), provided that (i) neither counterparty’s swap obligations are guaranteed by a U.S. person,⁶ and (ii) neither counterparty is a “Foreign Consolidated Subsidiary”⁷ nor a U.S. branch of a non-U.S. CSE. The chart from the CFTC proposal, on the next

page, outlines when CFTC uncleared margin requirements would apply to cross-border transactions.

If adopted, the CFTC’s cross-border approach for uncleared margin would be more consistent with the approach proposed by the Prudential Regulators in 2014, but still could create a number of regulatory disconnects both inside and outside of the CFTC’s regulatory regime. For example, the CFTC’s proposed definition of U.S. person differs both from the U.S. person definition in the CFTC cross-border guidance and the U.S. person definition adopted by the Securities and Exchange Commission in August 2014. Similarly, the CFTC proposal contains a definition of “guarantee” that may raise interpretive differences when compared with the general description of the term relied upon for purposes of the CFTC cross-border guidance. Lastly, the proposed definition of a “Foreign Consolidated Subsidiary” is based on a “consolidation test” rather than the “control test” used in the Prudential Regulators’ proposal.

The CFTC has asked for comment on these and a variety of other issues. The comment period for the CFTC proposal will close 60 days after the proposal is published in the Federal Register.

⁶ The proposal would define a “guarantee” to mean an arrangement where a party to a swap with a non-U.S. counterparty has a conditional or unconditional legally enforceable right of recourse against a U.S. person guarantor for the swap obligations of the non-U.S. counterparty.

⁷ A Foreign Consolidated Subsidiary would be a non-U.S. CSE whose financial statements are consolidated with a U.S. ultimate parent entity in accordance with U.S. generally accepted accounting principles.

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Application of the Proposed Rule

CSE	Counterparty	Proposed Approach
U.S. CSE or Non-U.S. CSE (including U.S. branch of a non-U.S. CSE and a Foreign Consolidated Subsidiary ("FCS")) whose obligations under the relevant swap are guaranteed by a U.S. person.	<ul style="list-style-type: none"> U.S. person (including U.S. CSE) Non-U.S. person (including non-U.S. CSE, FCS, and U.S. branch of a non-U.S. CSE) whose obligations under the relevant swap are guaranteed by a U.S. person 	U.S. (All)
	<ul style="list-style-type: none"> Non-U.S. person (including non-U.S. CSE, FCS, and U.S. branch of a non-U.S. CSE) whose obligations under the relevant swap are not guaranteed by a U.S. person 	U.S. (Initial Margin collected by CSE in column 1)
		Substituted Compliance (Initial Margin posted by CSE in column 1)
		U.S. (Variation Margin)
FCS whose obligations under the relevant swap are not guaranteed by a U.S. person or U.S. branch of a non-U.S. CSE whose obligations under the relevant swap are not guaranteed by a U.S. person	<ul style="list-style-type: none"> U.S. CSE Non-U.S. CSE (including U.S. branch of a non-U.S. CSE and FCS) whose obligations under the relevant swap are guaranteed by a U.S. person 	U.S. (Initial Margin posted by CSE in column 1)
		Substituted Compliance (Initial Margin collected by CSE in column 1)
		U.S. (Variation Margin)
	<ul style="list-style-type: none"> U.S. person (except as noted above for a CSE) Non-U.S. person whose obligations under the swap are guaranteed by a U.S. person (except a non-U.S. CSE, U.S. branch of a non-U.S. CSE, and FCS whose obligations are guaranteed, as noted above) Non-U.S. person (including non-U.S. CSE, U.S. branch of a non-U.S. CSE, and a FCS) whose obligations under the relevant swap are not guaranteed by a U.S. person 	Substituted Compliance (All)
Non-U.S. CSE (that is not a FCS or a U.S. branch of a non-U.S. CSE) whose obligations under the relevant swap are not guaranteed by a U.S. person	<ul style="list-style-type: none"> U.S. CSE Non-U.S. CSE (including U.S. branch of a non-U.S. CSE and FCS) whose obligations under the swap are guaranteed by a U.S. person 	U.S. (Initial Margin posted by CSE in column 1)
		Substituted Compliance (Initial Margin collected by CSE in column 1)
		U.S. (Variation Margin)
	<ul style="list-style-type: none"> U.S. person (except as noted above for a CSE) Non-U.S. person whose obligations under the swap are guaranteed by a U.S. person (except a non-U.S. CSE whose obligations are guaranteed, as noted above) U.S. branch of a Non-U.S. CSE or FCS, in each case whose obligations under the relevant swap are not guaranteed by a U.S. person 	Substituted Compliance (All)
	<ul style="list-style-type: none"> Non-U.S. person (including a non-U.S. CSE, but not a FCS or a U.S. branch of a non-U.S. CSE) whose obligations under the relevant swap are not guaranteed by a U.S. person 	Excluded

Source: Commodity Futures Trading Commission