

Derivatives Alert

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Prudential Regulators Finalize Margin Requirements for Non-Cleared Swaps

Federal banking regulators (Prudential Regulators)¹ have finalized much-anticipated rules (Final Rules)² relating to initial and variation margin requirements for certain swaps and security-based swaps that are not centrally cleared through a registered derivatives clearing organization or a registered clearing agency (such swaps, “non-cleared swaps”).³ Subject to certain exemptions, the Final Rules will apply to a non-cleared swap where at least one counterparty to the trade is both (1) registered either with the Commodity Futures Trading Commission (CFTC) as a swap dealer or major swap participant, or with the Securities and Exchange Commission (SEC) as a security-based swap dealer or major security-based swap participant (swap entity) and (2) subject to regulation by at least one of the Prudential Regulators (such a counterparty, a covered swap entity or CSE).⁴ The Final Rules implement a staggered compliance schedule beginning on September 1, 2016, and would not apply to non-cleared swaps entered into prior to their specified compliance dates unless those swaps are rolled over or renewed after the relevant compliance dates.

The Final Rules will require covered swap entities to post and collect minimum initial and variation margin amounts for non-cleared swaps with many of their counterparties. In adopting the Final Rules, the Prudential Regulators reaffirmed their policy objective

¹ The Prudential Regulators consist of the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Fed), the Federal Deposit Insurance Corporation (FDIC), the Farm Credit Administration and the Federal Housing Finance Agency. To date, the OCC, Fed and FDIC have all voted to approve the Final Rules.

² See “Margin and Capital Requirements for Covered Swap Entities,” available at https://www.fdic.gov/news/board/2015/2015-10-22_notice_dis_a_fr_final-rule.pdf. The Final Rules incorporate by reference an interim final rule (IFR) concurrently adopted by the Prudential Regulators that will exempt commercial end-users and certain small financial institutions from all non-cleared margin requirements under the Final Rules. See “Margin and Capital Requirements for Covered Swap Entities,” available at https://www.fdic.gov/news/board/2015/2015-10-22_notice_dis_a_fr_interim-final-rule.pdf (“IFR Exemptions”).

³ The Final Rules, though titled “Margin and Capital Requirements for Covered Swap Entities,” do not adopt new capital requirements, but instead require a covered swap entity to comply with regulatory capital rules already made applicable to that covered swap entity as part of its prudential regulatory regime.

⁴ The CFTC and SEC separately proposed non-cleared margin requirements that would apply to swap entities regulated by each respective agency that are not covered swap entities. See “Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants,” 79 Fed. Reg. 59898 (proposed October 3, 2014); “Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, Proposed Rule, 77 Fed. Reg. 70213” (proposed November 23, 2012). These requirements have not yet been finalized.

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in the 2014 rule proposal (2014 Proposal)⁵ that the posting and collection of margin should reduce buildups of large unsecured derivatives positions that can adversely affect financial stability. Like the 2014 Proposal, the Final Rules also take into account the risk posed by a covered swap entity's different types of counterparties in establishing the minimum margin requirements.

Although the Final Rules retain the general spirit and risk-based approach of the 2014 Proposal, they include a number of changes that the Prudential Regulators believe will reduce burdens on market participants. Among the more significant of these changes are:

- excluding from all margin requirements certain non-cleared swaps with commercial end users and small financial institutions;⁶
- increasing the annual swap activity threshold for financial end users (referred to as "material swaps exposure") that would trigger initial margin requirements with respect to those entities;
- expanding the types of collateral eligible to be used for initial and variation margin;
- aligning the "affiliate" definition (relevant to several parts of the Final Rules) with accounting consolidation standards rather than a "control" concept; and
- including special rules for non-cleared swaps between covered swap entities and their affiliates.

This client alert summarizes key aspects of the Final Rules and some of the differences from the 2014 Proposal. On page 7 is a [chart](#) of the significant requirements in the Final Rules, organized by counterparty category.

I. Margin Counterparty Categories

The Final Rules acknowledge that different types of counterparties pose different levels of risk to the financial system. Accordingly, the Final Rules adopt a risk-based approach to margin requirements for different types of counterparties — specifically, swap entities, financial end users with material swaps exposure and other counterparties including financial end users without material swap exposure. Unlike the 2014 Proposal, however, the Final Rules also include exemptions from all margin requirements for certain swaps with commercial end users and small financial institutions and include special provisions for a CSE's inter-affiliate swaps.

⁵ See "Margin and Capital Requirements for Covered Swap Entities," 79 Fed. Reg. 57348 (proposed September 24, 2014).

⁶ The provisions codifying these exemptions are subject to final approval after a public comment period scheduled to close on January 31, 2016.

A. Counterparty Category 1: CSE to Another Swap Entity

For swaps with other swap entities (including other CSEs), a CSE will be required to post initial margin⁷ and daily variation margin to, and collect initial and variation margin from, the swap entity counterparty.

B. Counterparty Category 2: CSE to Financial End User with Material Swaps Exposure

A CSE will be required to post initial margin⁸ and daily variation margin to, and collect initial margin and daily variation margin from, financial end users with material swaps exposures.

The Final Rules' definition of "financial end user" is similar to the proposed definition and, according to the Prudential Regulators, "is broad by design."⁹ A financial end user will have "material swaps exposure" when the financial end user and its affiliates had an average daily aggregate notional amount of non-cleared swaps, non-cleared security based swaps, foreign exchange forwards and foreign exchange swaps¹⁰ with all counterparties during June, July and August of the previous calendar year that exceeded \$8 billion. In other words, a financial end user's material swaps exposure calculation based on its June, July and August exposure in a calendar year determines whether the financial end user will be deemed to have a material swaps

⁷ If changes in portfolio composition or any other factors result in a change in the required initial margin amounts for any swap for which initial margin is required, a CSE will be required to post or collect additional initial margin, which could be as often as daily.

⁸ See supra note 7.

⁹ Under the Final Rules, the term financial end user includes: nonbank financial institutions supervised by the Board of Governors of the Federal Reserve System, depository institutions, foreign banks, state-licensed or registered credit or lending entities (but excluding entities registered or licensed solely on account of financing the entity's direct sales of goods or services to customers), broker-dealers, floor brokers, floor traders, introducing brokers, registered investment companies, business development companies, private funds, securitization vehicles, commodity pools, commodity pool operators, employee benefit plans, insurance companies, cooperatives that are financial institutions, U.S. intermediate holding companies established or designated for purposes of compliance with Regulation YY of the Board of Governors of the Federal Reserve System, and entities that are or would be a financial end user or swap entity if they were organized under the laws of the U.S. or any state.

¹⁰ In 2012, the secretary of the Treasury made a determination that physically settled foreign exchange forwards and foreign exchange swaps are not to be considered swaps under the Dodd-Frank Act. See "Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act," 77 Fed. Reg. 69694 (November 20, 2012). Although non-cleared margin requirements under the Final Rules do not apply to foreign exchange forward and foreign exchange swap transactions, foreign exchange forwards and foreign exchange swaps exposure will be relevant for determining material swaps exposure and compliance dates.

exposure for the entire next calendar year.¹¹ The Prudential Regulators increased the material swaps exposure threshold from the proposed \$3 billion to \$8 billion largely to be consistent with international standards.¹² Additionally, the Final Rules clarify that in calculating material swaps exposure, a swap between a financial end user and its affiliate (*i.e.*, an inter-affiliate swap) should be counted only one time (*i.e.*, either by the financial end user or the affiliate) and a swap that is otherwise subject to an exemption should not be counted (see Section D below).¹³

C. Counterparty Category 3: CSE to Other Counterparty

The Final Rules impose more nuanced margin requirements on CSEs with respect to swaps with “Other Counterparties.” “Other Counterparties” are counterparties that are not swap entities or financial end users with material swaps exposure. Other Counterparties include sovereigns, multilateral development banks, the Bank for International Settlements, commercial end users and financial end users without material swaps exposure. Note, however, that certain swaps between a CSE and a commercial end user or small financial institution are subject to an exemption from any of the new margin requirements, as discussed below. For those swaps with Other Counterparties that are not subject to an exemption, a CSE will be subject to the following requirements:

- Where the CSE faces any Other Counterparty except for a financial end user without material swaps exposure, a CSE only will be required to *collect* initial margin and variation margin at such times and in such forms and such amounts that the CSE determines appropriately addresses the credit risk posed by the counterparty and the risk of the swap. This could result in the CSE determining not to collect any initial margin or variation margin from the Other Counterparty. There will be no requirement that a CSE post initial margin or variation margin to the Other Counterparty.

¹¹ Unlike the 2014 Proposal, the Final Rules provide specifics on how initial margin requirements can change where a financial end user with material swaps exposure becomes a financial end user without material swaps exposure, and vice versa. Depending on several timing parameters, a CSE will not be required to exchange initial margin for any new or existing non-cleared swap with a financial end user whose swaps exposure changes from material in one year to non-material in the next year. Conversely and also depending on timing parameters, a CSE will be required to exchange initial margin for new swaps with a financial end user whose swaps exposure changes from non-material in one year to material in the next year. The Final Rules also address a change in status of other swap counterparties of a CSE (*e.g.*, an entity’s status changes from not being a swap entity to being a swap entity).

¹² The Basel Committee on Banking Supervision (BCBS) and the Board of the International Organization of Securities Commissions (“IOSCO”) developed an international framework for non-cleared margin requirements which called for a material swaps exposure threshold of €8 billion. See BCBS and IOSCO “Margin requirements for non-centrally cleared derivatives,” (September 2013), available at <https://www.bis.org/publ/bcbs261.pdf>.

¹³ A CSE may rely in good faith on reasonable representations of its counterparties in assessing whether it is transacting with a financial end user with material swaps exposure.

- Where the CSE faces an Other Counterparty that is a financial end user without material swaps exposure, a CSE will have discretion to collection initial margin but must collect and post variation margin. Thus, daily variation margin will be required for swaps with all financial end users.

D. Certain Swaps Between a CSE and a Commercial End User or Small Financial Institution

As required by the Terrorism Risk Insurance Program Reauthorization Act of 2015 (TRIPRA), the Prudential Regulators have adopted the IFR Exemptions that will exempt from the Final Rules’ margin requirements: (1) swaps with commercial end users that are entered into for hedging purposes and (2) swaps with a financial institution with total assets of \$10 billion or less if the institution uses the swap to hedge commercial risk. In the preamble to the Final Rules, the Prudential Regulators emphasized that the exemption is transaction-based, as opposed to counterparty-based. Thus, for example, if a commercial end user enters into a non-cleared swap with a CSE and the transaction is not for hedging purposes, then the swap would not be exempt and the CSE would treat the swap in accordance with the Other Counterparties requirements discussed above.

E. Swaps Between a CSE and an Affiliate

In response to numerous concerns raised by commenters, the Final Rules include special provisions for swaps between a CSE and an affiliate. The Prudential Regulators also modified the term “affiliate,” which is used not only in the inter-affiliate swap provisions described below, but also in the conditions for third-party custodians holding segregated collateral, in the definitions of “material swaps exposure” and initial margin threshold amount, and in determining the compliance dates. This new affiliate definition uses financial accounting standards as a trigger for affiliation. Instead of the proposed legal control test that concerned a number of commenters, the Final Rules generally determine affiliate status based on whether and how a company is or would be consolidated with another company on financial statements prepared in accordance with U.S. Generally Accepted Accounting Principles, the International Financial Reporting Standards or other similar standards.¹⁴

While a CSE still will be required to collect initial margin from an affiliate that is either a swap entity or financial end user with material swaps exposure, the CSE will not be required to post initial margin to any affiliate other than another Covered Swap Entity. However, with respect to an affiliate who is a financial end user with material swaps exposure, the CSE will be required

¹⁴ Alternatively, under the Final Rules, a company will be considered an affiliate of another company if the relevant Prudential Regulator concludes that either company provides significant support to, or is materially subject to the risks of losses of, the other company.

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to calculate the amount of initial margin that would be required to be posted to such affiliate and provide documentation of that amount to the affiliate on a daily basis. A CSE will be required to collect daily variation margin from, and post daily variation margin to, any affiliate counterparty that is a swap entity or financial end user.

II. Calculation of Margin Amounts

A. Initial Margin Calculation

Like the 2014 Proposal, the Final Rules set forth two alternative methods for calculating initial margin: (1) a standardized margin schedule attached to the Final Rules that expresses initial margin as a percentage of the notional amount of the swap or (2) an internal initial margin model approved by the relevant Prudential Regulator. The standardized margin approach allows for the recognition of risk offsets through the use of a net-to-gross ratio in cases where a portfolio of non-cleared swaps is executed under an eligible master netting agreement¹⁵ (EMNA) (e.g., an ISDA). All non-cleared swaps subject to the same EMNA and subject to the Final Rules' requirements can be netted against each other across asset classes in the calculation of the standardized margin net-to-gross ratio. In contrast, the internal model approach only allows for portfolio offsets for swaps *within* the same asset class — commodities, credit, equity, or foreign exchange/interest rate (as a single asset class) — that are governed by the same EMNA.

B. Variation Margin Calculation

Variation margin will be equal to the change in value of the swap since the counterparties' previous exchange of variation margin, calculated on at least a daily basis. A CSE could calculate variation margin on an aggregate net basis for swaps governed by an EMNA.¹⁶

III. Maximum Initial Margin Threshold and Minimum Transfer Amount

The Final Rules permit a covered swap entity to adopt a maximum initial margin threshold of \$50 million,¹⁷ below which it need not collect or post initial margin from or to swap entities

¹⁵ An eligible master netting agreement is a master netting agreement that meets certain conditions as detailed in the Final Rules. These conditions include, but are not limited to, requirements with respect to the CSE's right to terminate the contract and liquidate collateral.

¹⁶ Swaps entered into before the applicable compliance date that are subject to the master netting agreement would need to be included in the aggregate calculation.

¹⁷ The \$50 million threshold represents the aggregate credit exposure resulting from all non-cleared swaps and non-cleared security-based swaps between a covered swap entity and its affiliates and a counterparty and its affiliates. Thus, the threshold would be calculated on a consolidated entity basis.

and financial end users with material swaps exposures. The Prudential Regulators lowered the maximum initial margin threshold from the proposed \$65 million to \$50 million to align the U.S. dollar-denominated numerical amounts in the Final Rules with those in the 2013 framework and to be consistent with amounts that have been proposed in margin rules by the European and Japanese authorities. Under the special provisions for inter-affiliate swaps, each affiliate facing a CSE may be granted an initial margin threshold of \$20 million.

Like the 2014 Proposal, the Final Rules do not permit a CSE to adopt a threshold amount below which it need not post or collect variation margin on swaps with swap entities or financial end users. However, the Final Rules allow for a minimum transfer amount, such that a CSE is not required to collect or post any margin from or to any individual counterparty unless and until the combined amount of initial and variation margin that must be collected or posted under the Final Rules (but has not yet been exchanged with the counterparty) is greater than \$500,000. The Prudential Regulators explained that the minimum transfer amount is meant to generally alleviate the operational burdens associated with making *de minimis* margin transfers.

IV. Types of Eligible Collateral

The Final Rules expand the list of types of collateral that are eligible to be used to satisfy initial and variation margin requirements.

For initial margin, the Final Rules added to the 2014 Proposal's list of types of eligible collateral interests in pooled investment funds that invest either in U.S. government securities or in securities issued by the European Central Bank or a sovereign entity that is assigned no higher than a 20 percent risk weight under the capital rules applicable to the covered swap entity. The other types of eligible collateral for initial margin, carried over from the 2014 Proposal, are: cash; certain assets expected to remain highly liquid during a period of financial stress (such as debt securities issued or guaranteed by the U.S. Department of Treasury or another U.S. government agency, the Bank for International Settlements, the International Monetary Fund, the European Central Bank or multilateral development banks); U.S. government-sponsored enterprises' debt securities; certain foreign government debt securities; certain corporate debt securities; certain listed equities; and gold. Given that CSEs have discretion to collect and post initial margin for swaps with Other Counterparties, the Final Rules allow a CSE to collect or post initial margin in any form of collateral for such swaps.

For variation margin, the Final Rules greatly expand the scope of eligible collateral types for swaps with a financial end user. Rather than being restricted to using cash (denominated in U.S. dollars or the currency of settlement), as the 2014 Proposal

would have required, a CSE and financial end user will be able to exchange funds denominated in any major currency as well as use the types of non-cash collateral that are eligible for initial margin requirements. The expansion of eligible collateral types for variation margin does not apply to swaps between a CSE and another swap entity, as the only permissible eligible collateral for variation margin for a CSE's swaps with another swap entity is immediately available cash funds denominated in U.S. dollars or the currency of settlement. For swaps between CSEs and Other Counterparties (except for financial end users), the CSE has discretion to collect and post variation margin and may use any form of collateral for the variation margin.

With respect to both initial margin and variation margin requirements, non-cash collateral permitted under the Final Rules will be subject to additional "haircuts" or discounts as set forth in Appendix B of the Final Rules.¹⁸

V. Segregation of Collateral

Like the 2014 Proposal, the Final Rules require that any collateral (other than collateral for variation margin) that a CSE *posts* (including collateral in excess of what is required under the Final Rules) must be segregated at one or more custodians that are not affiliates of the CSE or the counterparty (a third-party custodian). Furthermore, consistent with the 2014 Proposal, a CSE will be required to place the initial margin it *collects* from a swap entity or financial end user with material swaps exposure at a third-party custodian. For swaps between a CSE and its affiliates, however, the Final Rules allow the CSE to serve as the custodian for non-cash collateral that the CSE collects from an affiliate or to have an affiliate of the CSE serve as the custodian for that collateral. Where a third-party custodian is required, the custodial agreement between the CSE and third-party custodian must prohibit rehypothecation, although substitutions and reinvestments are allowed under certain specified circumstances. A CSE will not be required to segregate the initial margin it collects from Other Counterparties, and there will be no segregation requirements for variation margin with respect to any counterparty. Nevertheless, even where the segregation requirements do not apply, the Final Rules do not preclude parties from using a third-party custodian.

VI. Documentation of Margin Matters

A CSE is required to execute trading documentation that grants the CSE the contractual right to collect margin in amounts and under the circumstances necessary to meet the Final Rules' requirements, details the procedures for determining the value of each swap for variation margin purposes and the procedures

for calculating initial margin, and provides valuation dispute procedures.

VII. Cross-Border Application of Margin Requirements

Like the 2014 Proposal, the Final Rules specify how the margin requirements will be applied in a cross-border context. An exemption from the margin requirements will apply to swaps between foreign CSEs and foreign counterparties, provided that no U.S. entity guarantees either party's obligations under such swaps. Swaps not subject to this total exemption (*e.g.*, swaps between a foreign CSE and a U.S. counterparty) may be eligible for substituted compliance whereby the CSE could satisfy the requirements in the Final Rules by complying with the requirements of its home jurisdiction. For substituted compliance to apply, the Prudential Regulators would need to determine that the foreign jurisdiction's requirements are comparable to those in the Final Rules. Notably, swaps transacted by U.S. CSEs, including swaps transacted out of foreign branches of U.S. CSEs, would not be eligible for substituted compliance.¹⁹ Finally, there are special rules for swaps with a counterparty located in a jurisdiction where inherent limitations in the legal or operational infrastructure make it impracticable for the CSE and counterparty to post initial margin in compliance with the Final Rules.

VIII. Compliance Dates

The compliance timetable in the Final Rules pushes further out the 2014 Proposal's compliance dates (which would have begun on December 15, 2015). Under the Final Rules, initial margin requirements will be phased in between September 1, 2016, and September 1, 2020, depending on the average daily notional amount of non-cleared swaps, non-cleared security-based swaps, foreign exchange forwards, and foreign exchange swaps of the CSE (combined with its affiliates) and the CSE's counterparty (combined with its affiliates) for each business day during March, April and May of that year. Starting on September 1, 2016, variation margin requirements will apply to large CSEs (*i.e.*, where both the CSE combined with its affiliates and the CSE's counterparty combined with its affiliates have an average daily aggregate notional amount of non-cleared swaps, non-cleared security-based swaps, foreign exchange forwards and foreign exchange swaps for March, April and May of 2016 that exceeds \$3 trillion). Variation margin requirements will apply to all remaining CSEs starting on March 1, 2017. Although non-cleared swaps entered into prior to these compliance dates will not be subject to the relevant margin requirements, a novation or amendment after one of the compliance dates could trigger the relevant margin requirement for the swap.

¹⁸The limits on eligible collateral and application of a haircut would not apply to margin collected in excess of what is required by the Final Rules.

¹⁹A CSE would, however, be permitted to calculate the amount of initial margin it must post to its counterparty pursuant to the host jurisdiction's requirements if that jurisdiction's requirements are determined to be comparable.

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The Prudential Regulators have recognized that CSEs will be making operational and legal changes to their current swaps business operations in order to comply with the new margin requirements, including potential changes to internal risk management and other systems, trading documentation, collateral arrangements, and operational and technology infrastructure. As the impact of the Final Rules extends well beyond CSEs and swap entities, financial end users and Other Counterparties that are swap counterparties to CSEs also may need to review their operations and legal documentation and make adjustments to

prepare them for posting and collecting margin on non-cleared swaps next year and in the coming years.²⁰

²⁰The International Swaps and Derivatives Association (ISDA) has undertaken efforts to facilitate such changes by developing a standardized initial margin model to be used by CSEs. ISDA also is working to revise standard collateral documentation to be compliant with the Final Rules and is developing and defining standard business and technology practices for margin calculations, notifications, and settlement, collateral eligibility and segregation. See "ISDA Statement on the Revised Implementation Date for Non-Cleared Derivatives Margin Rules," <http://www2.isda.org/news/isda-statement-on-the-revised-implementation-date-for-non-cleared-derivatives-margin-rules> (March 18, 2015).

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Prudential Regulators' Final Non-Cleared Margin Requirements for Covered Swap Entities (CSEs)

Counterparty Type	Initial Margin	Calculating Initial Margin	Initial Margin Thresholds	Acceptable Initial Margin Collateral	Initial Margin Segregation	Variation Margin	Acceptable Variation Margin Collateral
Swap Entity (including other CSEs)	CSE must collect from (and post to) at least the IM collection amount, which could be daily depending on how often changes in portfolio composition and other factors occur	CSE may use the standardized margin schedule or an internal margin model approved by the relevant Prudential Regulator	CSE may adopt a maximum IM threshold amount of \$50 million (\$20 million for affiliates) in aggregate credit exposure with a counterparty, below which it need not collect or post	Cash, gold, U.S. government bonds, and certain corporate bonds, foreign government bonds, and equities (subject to minimum haircuts)	All IM posted by CSE (including excess) and IM collected by CSE up to IM collection amount must be segregated at a third-party custodian. CSE or CSE affiliate can be custodian for IM collected from an affiliate	CSE must collect VM from and post VM to the counterparty at least once per business day	Only U.S. dollars or the currency in which payment obligations under the swap are required to be settled
Financial End User With Material Swaps Exposure	Same as above, except for affiliates, CSE not required to post (instead, only required to notify the affiliate of the amount that otherwise would be required)	Same as above	Same as above (for affiliates, \$20 million threshold amount applies when calculating amount that otherwise would be required to post)	Same as above	Same as above	Same as above	Same as above, plus any major currency and any collateral allowed as IM
Financial End User Without Material Swaps Exposure	CSE not required to post. CSE required to collect at such times and in such forms and amounts (if any) that CSE determines appropriate to address counterparty credit risk and risk of the swap	At CSE discretion	At CSE discretion	At CSE discretion	IM collected by CSE (if any) not required to be segregated; if IM ever posted by CSE (never required), must be segregated at a third-party custodian	Same as above	Same as above
Other Counterparty (except not a financial end user without material swaps exposure (see above) and not a commercial end user or small financial institution that hedges (see below))	Same as above	Same as above	Same as above	Same as above	Same as above	CSE not required to post. CSE required to collect at such times and in such forms and amounts (if any) that CSE determines appropriate to address counterparty credit risk and risk of the swap	At CSE discretion
Commercial End User or Small Financial Institution That Hedges	N/A	N/A	N/A	N/A	N/A	N/A	N/A

IM = Initial Margin; VM = Variation Margin