

# Derivatives Alert

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## Prudential Regulators Extend Swaps Clearing Exemptions and Exceptions to Non-Cleared Swap Margin Requirements

On August 2, 2016, federal banking regulators (Prudential Regulators)<sup>1</sup> adopted a final rule (PR Margin Exemptions)<sup>2</sup> implementing exemptions from the Prudential Regulators' impending initial and variation margin requirements for non-cleared<sup>3</sup> swaps (PR Margin Requirements).<sup>4</sup> The PR Margin Exemptions mirror the exemptions and exceptions from the mandatory clearing of certain non-cleared swaps or non-cleared security-based swaps of specified counterparties granted by the Commodity Futures Trading Commission (CFTC)<sup>5</sup> and Securities and Exchange Commission (SEC).<sup>6</sup>

**Background.** Pursuant to the PR Margin Requirements, registered swap dealers (SDs), major swap participants (MSPs), security-based swap dealers (SBSDs) and major security-based swap participants (MSBSPs) that are regulated by any of the Prudential Regulators (each a covered swap entity)<sup>7</sup> soon will be required to collect and post various initial and variation margin payments depending on the counterparty for all non-cleared

<sup>1</sup> Prudential Regulators consist of the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency.

<sup>2</sup> See 81 Fed. Reg. 50605 (August 2, 2016).

<sup>3</sup> A swap is non-cleared if it is not centrally cleared through a registered derivatives clearing organization or registered clearing agency.

<sup>4</sup> See 80 Fed. Reg. 74840 (November 30, 2015). The compliance date for the PR Margin Requirements begins on September 1, 2016, for some counterparties, with initial margin compliance phased in over four years and variation margin compliance fully implemented on March 1, 2017. For more information about the PR Margin Requirements, see November 2, 2015, Skadden client alert "[Prudential Regulators Finalize Margin Requirements for Non-Cleared Swaps](#)." The PR Margin Exemptions will become effective on October 1, 2016.

<sup>5</sup> See 7 U.S.C. § 2(h) (2012). For additional information regarding the CFTC's clearing requirement and end-user exception (initially adopted in Part 39 of the CFTC regulations but subsequently restated as Part 50 of the CFTC's regulations), see August 15, 2012, Skadden client alert "[CFTC Takes Steps to Implement the Clearing Regime for Swaps and Finalizes the Exception From Clearing for Commercial End-Users](#)."

<sup>6</sup> See 15 U.S.C. § 78c-3 (2012). The SEC has not yet made determinations requiring particular types of security-based swaps to be cleared and has not yet adopted final rules related to eligibility. The SEC also has not yet adopted exemptions or exceptions from the mandatory clearing requirement.

<sup>7</sup> 80 Fed. Reg. at 74841 (defining "covered swap entity" to be a "swap entity," or "a person that is registered with the [CFTC] as a swap dealer or major swap participant ... or a person that is registered with the [SEC] as a security-based swap dealer or a major security-based swap participant" that is regulated by one of the Prudential Regulators and, therefore, subject to the Prudential Regulators' rule).

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swaps and security-based swaps.<sup>8</sup> In adopting the non-cleared margin rules, the Prudential Regulators also published interim rules<sup>9</sup> to implement 2015 amendments to the Dodd-Frank Act,<sup>10</sup> which provided that certain swaps and security-based swaps that qualify for an exemption from the CFTC or SEC's clearing mandate also would be exempt from any Prudential Regulator non-cleared margin requirements. The PR Margin Exemptions adopt the Prudential Regulators' interim rule with no additional changes.<sup>11</sup>

**Eligibility Requirements.** The PR Margin Exemptions specify that non-cleared swaps and non-cleared security-based swaps entered into between a covered swap entity and one of the following types of entities are exempt from the PR Margin Requirements:

1. **Non-Financial Entities:** Entities defined to include commercial end users, small banks, savings associations, Farm Credit System institutions, credit unions and captive finance companies<sup>12</sup> that are excepted from the mandatory clearing requirement under sections 2(h)(7)(A) of the Commodity Exchange Act (CEA) or 3(C)(g)(1) of the Securities Exchange Act (SEA);<sup>13</sup>
2. **Cooperative Entities:** Cooperatives that are financial entities that enter into swaps either in connection with originating loans for their members or to hedge or mitigate commercial

risk related to loans or certain swaps with their members that are exempted from the mandatory clearing requirement under Part 50 of the CFTC regulations;<sup>14</sup> and

3. **Treasury Affiliates:** Affiliates of persons who qualify for an exception from the clearing requirements under CEA Section 2(h)(7)(A) that are excepted from the mandatory clearing requirement under sections 2(h)(7)(D) of the CEA or 3(C)(g)(4) of the SEA.<sup>15</sup>

Consistent with the CFTC and SEC exemptions and exceptions described above, counterparties falling within any of the three classes specified in the PR Margin Exemptions must enter into the non-cleared swap or non-cleared security-based swap to hedge or mitigate commercial risk in order to be exempted from the PR Margin Requirements. Additionally, eligible counterparties must report to either the CFTC or the SEC how they generally meet financial obligations associated with entering into non-cleared swaps or non-cleared security-based swaps. The PR Margin Exemptions contemplate that compliance with this reporting requirement can be satisfied by the CFTC regulatory requirements, and ultimately the SEC regulatory requirements, for clearing.<sup>16</sup>

<sup>8</sup> See 7 U.S.C. § 6s(e)(2)(A) (2012); 15 U.S.C. § 78o-10(e)(2)(A) (2012). See November 2, 2015, Skadden client alert "[Prudential Regulators Finalize Margin Requirements for Non-Cleared Swaps](#)" for a description of the four types of counterparties contemplated by the PR Margin Requirements. The CFTC also adopted substantially similar margin rules for non-cleared swaps entered into by any SD or MSP that is not regulated by a Prudential Regulator. See 81 Fed. Reg. 636 (January 6, 2016). The SEC has proposed but not yet adopted margin rules for non-cleared security-based swaps. See "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).

<sup>9</sup> See 80 Fed. Reg. 74916 (November 30, 2015).

<sup>10</sup> See Title III of the Terrorism Risk Insurance Reauthorization Act of 2015 (The Business Risk Mitigation and Price Stabilization Act of 2015), Pub. L. 114-1, 129 Stat. 3 (2015).

<sup>11</sup> The CFTC also published a substantially similar interim final rule as part of its final non-cleared margin rulemaking. See 81 Fed. Reg. 636 (January 6, 2016). The CFTC has not yet finalized its interim rule but will likely do so.

<sup>12</sup> See 81 Fed. Reg. at 50608 (defining "captive finance company" as an entity whose primary purpose is to provide financing, and use derivatives, for the purposes of hedging the underlying commercial interest rate and foreign exchange risk to facilitate the lease of products owned or manufactured by a parent company, or a subsidiary of a parent company). There is no corresponding exclusion from clearing for captive finance companies in the SEA.

<sup>13</sup> 7 U.S.C. § 2(h)(7)(A) (2012); 15 U.S.C. § 78c-3(g)(1) (2012).

<sup>14</sup> 7 U.S.C. § 6(c)(1) (2012); 17 C.F.R. § 50.51. There is no corresponding exemption under the SEA or SEC regulations.

<sup>15</sup> 7 U.S.C. § 2(h)(7)(D) (2012); 15 U.S.C. § 78c-3(g)(4) (2012).

<sup>16</sup> See 81 Fed. Reg. at 50609-50610.