6351-01-P

**COMMODITY FUTURES TRADING COMMISSION**

**17 CFR Parts 23 and 140**

**RIN 3038-AC97**

# Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants

**AGENCY:** Commodity Futures Trading Commission.

**ACTION:** Final rule and interim final rule.

**SUMMARY:** The Commodity Futures Trading Commission ("Commission" or "CFTC") is adopting regulations to implement a particular provision of the Commodity Exchange Act ("CEA"), as added by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). This provision requires the Commission to adopt initial and variation margin requirements for certain swap dealers ("SDs") and major swap participants ("MSPs"). The final rules would establish initial and variation margin requirements for SDs and MSPs but would not require SDs and MSPs to collect margin from non-financial end users.

The Commission is also adopting and inviting comment on an interim final rule that will exempt certain uncleared swaps with certain counterparties from these margin requirements. This interim final rule implements Title III of the Terrorism Risk Insurance Program Reauthorization Act of 2015 ("TRIPRA"), which exempts from the margin rules uncleared swaps in which a counterparty qualifies for an exemption or exception from clearing under the Dodd-Frank Act.

**DATES:** The rules will become effective April 1, 2016. Comments on the interim final rule must be received on or before [**INSERT DATE 30 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER**].

**ADDRESSES:** You may submit comments on the interim final rule by any of the following methods:

- CFTC website: http://comments.cftc.gov. Follow the instructions for submitting comments through the Comments Online process on the website.
- Mail: Send to Christopher Kirkpatrick, Secretary of the Commission, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581.
- Hand Delivery/Courier: Same as Mail, above.
- Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments.

Please submit your comments using only one of these methods.

All comments must be submitted in English, or if not, accompanied by an English translation. Comments will be posted as received to http://www.cftc.gov. You should submit only information that you wish to make available publicly. If you wish the Commission to consider information that may be exempt from disclosure under the Freedom of Information Act, a petition for confidential treatment of the exempt information may be submitted according to the procedures established in § 145.9 of the Commission's regulations. [1]

[1] 17 CFR 145.9. Commission regulations referred to herein are found at 17 CFR Chapter I.

The Commission reserves the right, but shall have no obligation, to review, pre-screen, filter, redact, refuse or remove any or all of your submission from www.cftc.gov that it may deem to be inappropriate for publication, such as obscene language. All submissions that have been redacted or removed that contain comments on the merits of the rulemaking will be retained in the public comment file and will be considered as required under the Administrative Procedure Act and other applicable laws, and may be accessible under the Freedom of Information Act.

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**SUPPLEMENTARY INFORMATION:**

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## I. Background

### A. Statutory Authority

On July 21, 2010, President Obama signed the Dodd-Frank Act.[2] Title VII of the Dodd-Frank Act amended the CEA[3] to establish a comprehensive regulatory framework designed to reduce risk, to increase transparency, and to promote market integrity within the financial system by, among other things: (1) providing for the registration and regulation of SDs and MSPs; (2) imposing clearing and trade execution requirements on standardized derivative products; (3) creating recordkeeping and real-time reporting regimes; and (4) enhancing the Commission's rulemaking and enforcement authorities with respect to all registered entities and intermediaries subject to the Commission's oversight.

[2] See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).
[3] 7 U.S.C. 1 et seq.

Section 731 of the Dodd-Frank Act added a new section 4s to the CEA setting forth various requirements for SDs and MSPs. Section 4s(e) mandates the adoption of rules establishing margin requirements for uncleared swaps of SDs and MSPs.[4] Each SD and MSP for which there is a Prudential Regulator, as defined below, must meet margin requirements for their uncleared swaps established by the applicable Prudential Regulator, and each SD and MSP for which there is no Prudential Regulator must comply with the Commission's regulations governing margin.

The term Prudential Regulator is defined in section 1a(39) of the CEA, as amended by Section 721 of the Dodd-Frank Act. This definition includes the Federal Reserve Board ("FRB"); the Office of the Comptroller of the Currency ("OCC"); the Federal Deposit Insurance Corporation ("FDIC"); the Farm Credit Administration; and the Federal Housing Finance Agency.

The definition specifies the entities for which these agencies act as Prudential Regulators. These consist generally of federally insured deposit institutions, farm credit banks, federal home loan banks, the Federal Home Loan Mortgage Corporation, and the Federal National Mortgage Association. The FRB is the Prudential Regulator under section 4s not only for certain banks, but also for bank holding companies, certain foreign banks treated as bank holding companies, and certain subsidiaries of these bank holding companies and foreign banks.

The FRB is not, however, the Prudential Regulator for nonbank subsidiaries of bank holding companies, some of which are required to be registered with the

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[4] Section 4s(e) also directs the Commission to adopt capital requirements for SDs and MSPs. The Commission proposed capital rules in 2011. Capital Requirements for Swap Dealers and Major Swap Participants, 76 FR 27802 (May 12, 2011). The Commission will address capital requirements in a separate release.

Commission as SDs or MSPs. Therefore, the Commission is required to establish margin requirements for uncleared swaps for all registered SDs and MSPs that are not subject to a Prudential Regulator. These include, among others, nonbank subsidiaries of bank holding companies, as well as certain foreign SDs and MSPs.

Specifically, section 4s(e)(1)(B) of the CEA provides that each registered SD and MSP for which there is not a Prudential Regulator shall meet such minimum capital requirements and minimum initial margin and variation margin requirements as the Commission shall by rule or regulation prescribe.

Section 4s(e)(2)(B) provides that the Commission shall adopt rules for SDs and MSPs, with respect to their activities as an SD or an MSP, for which there is not a Prudential Regulator imposing (i) capital requirements and (ii) both initial and variation margin requirements on all swaps that are not cleared by a registered derivatives clearing organization ("DCO").

Section 4s(e)(3)(A) provides that to offset the greater risk to the SD or MSP and the financial system arising from the use of swaps that are not cleared, the requirements imposed under section 4s(e)(2) shall (i) help ensure the safety and soundness of the SD or MSP and (ii) be appropriate for the risk associated with the uncleared swaps.

Section 4s(e)(3)(C) provides, in pertinent part, that in prescribing margin requirements the Prudential Regulator and the Commission shall permit the use of noncash collateral the Prudential Regulator or the Commission determines to be consistent with (i) preserving the financial integrity of markets trading swaps and (ii) preserving the stability of the United States financial system.

Section 4s(e)(3)(D)(i) provides that the Prudential Regulators, the Commission, and the Securities and Exchange Commission ("SEC") shall periodically (but not less frequently than annually) consult on minimum capital requirements and minimum initial and variation margin requirements.

Section 4s(e)(3)(D)(ii) provides that the Prudential Regulators, Commission and SEC shall, to the maximum extent practicable, establish and maintain comparable minimum capital and minimum initial and variation margin requirements, including the use of noncash collateral, for SDs and MSPs.

B. International Standards

In October 2011, the Basel Committee on Banking Supervision ("BCBS") and the International Organization of Securities Commissions ("IOSCO"), in consultation with the Committee on Payment and Settlement Systems ("CPSS") and the Committee on Global Financial Systems ("CGFS"), formed a working group to develop international standards for margin requirements for uncleared swaps. Representatives of more than 20 regulatory authorities participated. From the United States, the CFTC, the FDIC, the FRB, the OCC, the Federal Reserve Bank of New York, and the SEC were represented.

In July 2012, the working group published a proposal for public comment.[5] In addition, the group conducted a Quantitative Impact Study ("QIS") to assess the potential liquidity and other quantitative impacts associated with margin requirements.[6]

After consideration of the comments on the proposal and the results of the QIS, the group published a near-final proposal in February 2013 and requested comment on

[5] BCBS/IOSCO, Consultative Document, Margin requirements for non-centrally cleared derivatives (July 2012).
[6] BCBS/IOSCO, Quantitative Impact Study, Margin requirements for non-centrally cleared derivatives (November 2012).

several specific issues.[7] The group considered the additional comments in finalizing the recommendations set out in the report.

The final report was issued in September 2013.[8] This report (the "2013 international framework") articulates eight key principles for non-cleared derivatives margin rules, which are described below. These principles represent the minimum standards approved by BCBS and IOSCO and their recommendations to the regulatory authorities in member jurisdictions of these organizations.

C. Proposed Rules

The Commission initially proposed margin requirements for SDs and MSPs in 2011. In response to the 2013 international framework, the Commission reproposed margin requirements in September 2014.[9]

In developing the proposed rules, the Commission staff worked closely with the staff of the Prudential Regulators.[10] In most respects, the proposed rules would establish a framework for margin requirements similar to the Prudential Regulators' proposal. The proposed rules were consistent with the 2013 international framework. In some instances, as contemplated in the framework, the proposed rules provided more detail than the framework. In a few other instances, the proposed rules were stricter than the framework.

D. Subsequent Amendment to Dodd-Frank

[7] BCBS/IOSCO, Consultative Document, Margin requirements for non-centrally cleared derivatives (February 2013).
[8] BCBS/IOSCO, Margin requirements for non-centrally cleared derivatives (September 2013) ("BCBS/IOSCO Report").
[9] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 FR 59898 (Oct. 3, 2014).
[10] As required by section 4s of the CEA, the Commission staff also has consulted with the SEC staff.

On January 12, 2015, the President signed Title III of TRIPRA. Title III amends sections 731 and 764 of the Dodd-Frank Act to exempt certain transactions of certain commercial end users and others from the Commission's capital and margin requirements.[11] Specifically, section 302 of Title III amends sections 731 and 764 of the Dodd-Frank Act to provide that the Commission's rules on margin requirements under those sections shall not apply to a swap in which a counterparty: (1) qualifies for an exception under section 2(h)(7)(A) of the Commodity Exchange Act; (2) qualifies for an exemption issued under section 4(c)(1) of the Commodity Exchange Act for cooperative entities as defined in such exemption, or (3) satisfies the criteria in section 2(h)(7)(D) of the Commodity Exchange Act.

Section 303 of TRIPRA requires that the Commission implement the provisions of Title III, "Business Risk Mitigation and Price Stabilization Act of 2015," by promulgating an interim final rule, and seeking public comment on the interim final rule. The Commission is adopting § 23.150(b) as part of this final rule. These exemptions are transaction-based, as opposed to counterparty-based. The Commission will be requesting comment, as required by TRIPRA. If necessary, the Commission will amend § 23.150(b) after receiving comments on the interim final rule.

## II. Final Regulations

### A. Overview

The discussion below addresses: (i) the products covered by the proposed rules; (ii) the market participants covered by the proposed rules; (iii); the nature and timing of the margin obligations; (iv) the methods of calculating initial margin; (v) the methods of

[11] Pub. L. 114-1, 129 Stat. 3.

calculating variation margin; (vi) permissible forms of margin; (vii) custodial arrangements; (viii) documentation requirements; (ix) the treatment of inter-affiliate swaps;[12] and (x) the implementation schedule. The Commission received 58 written comments on the proposal.[13] They are discussed in the applicable sections.

The rules adopted herein essentially provide for the same treatment as the rules recently adopted by the Prudential Regulators[14] with a few exceptions. The areas where there are differences are (i) the treatment of certain treasury affiliates, (ii) the anti-evasion provision in the definition of margin affiliate, (iii) the model approval process, (iv) the calculation of variation margin and related documentation requirements, and the (v) treatment of inter-affiliate trades. Each of these differences is discussed in the applicable section below.

The Prudential Regulators also issued a provision addressing cross-border application of their margin rule. The Commission will address this aspect of the rule in a separate rulemaking.[15]

B. Products

1. Proposal

As noted above, section 4s(e)(2)(B)(ii) of the CEA directs the Commission to establish both initial and variation margin requirements for certain SDs and MSPs "on all

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[12] Where appropriate, the preamble uses the term affiliate to mean a margin affiliate and the term subsidiary to mean margin subsidiary, as they are defined in § 23.151.
[13] The written submissions from the public are available in the comment file on www.cftc.gov. They include, but are not limited to those listed in Appendix A. In citing these comments, the Commission used the abbreviations set forth in the appendix.
[14] Margin and Capital Requirements for Covered Swap Entities, 80 FR 74840 (Nov. 30, 2015).
[15] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 80 FR 41376 (July 14, 2015).

swaps that are not cleared." As a result, the Commission's proposal covered swaps that are uncleared swaps[16] and that are executed after the applicable compliance date.[17]

The term "cleared swap" is defined in section 1a(7) of the CEA to include any swap that is cleared by a DCO registered with the Commission. The Commission notes, however, that SDs and MSPs also clear swaps through foreign clearing organizations that are not registered with the Commission. The Commission believes that a clearing organization that is not a registered DCO must meet certain basic standards in order to avoid creating a mechanism for evasion of the uncleared margin requirements. Accordingly, the Commission proposed to include in the definition of cleared swaps certain swaps that have been accepted for clearing by an entity that has received a no action letter or other exemptive relief from the Commission to clear such swaps for U.S. persons without being registered as a DCO.

As a result of the determination by the Secretary of the Treasury to exempt foreign exchange swaps and foreign exchange forwards from the definition of swap,[18] under the proposal the following transactions would not be subject to the requirements: (i) foreign exchange swaps; (ii) foreign exchange forwards; and (iii) the fixed, physically settled foreign exchange transactions associated with the exchange of principal in cross-currency swaps.

In a cross-currency swap, the parties exchange principal and interest rate payments in one currency for principal and interest rate payments in another currency. The exchange of principal occurs upon the inception of the swap, with a reversal of the

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[16] The term uncleared swap is defined in proposed Regulation 23.151.
[17] A schedule of compliance dates is set forth in proposed Regulation 23.160.
[18] Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, 77 FR 69694 (Nov. 20, 2012).

exchange of principal at a later date that is agreed upon at the inception of the swap. 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. Accordingly, the Commission proposed to treat that portion of a cross-currency swap that is a fixed exchange of principal in a manner that is consistent with the treatment of foreign exchange forwards and swaps. This treatment of cross-currency swaps was limited to cross-currency swaps and did not extend to any other swaps such as non-deliverable currency forwards.

2. Comments

The Commission received several comments involving products. Commenters expressed support for the Commission's decision to exempt foreign exchange forwards and swaps[19] and swaps cleared by an exempt derivatives clearing organization from margin requirements.[20] One commenter asked for clarification that commodity trade options are not subject to the margin requirements.[21]

3. Discussion

The Commission is adopting this aspect of the final regulations substantially as proposed. The Commission is modifying the definition of uncleared swap to eliminate the reference to no-action letters and to require that any exemptive relief be provided by Commission order.

[19] See GFXD (initial margin should not apply to physically-settled foreign exchange swaps and forwards and variation margin should be applied via supervisory guidance or national regulation) and CPFM.
[20] See ISDA and Sifma (any swap cleared by a derivatives clearing organization whether registered or not should be exempt from margin requirements).
[21] See BP. To the extent that any financial instrument is an uncleared swap, it will be covered under the final rule.

Under sections 4s(e), the Commission is directed to impose initial and variation margin requirements on all swaps that are not cleared by a registered derivatives clearing organization. The Commission is interpreting this statutory language to mean all swaps that are not cleared by a registered derivatives clearing organization or a derivatives clearing organization that the Commission has exempted from registration as provided under the CEA.

In particular, the CEA prohibits persons from engaging in a swap that is required to be cleared unless they submit such swaps for clearing to a derivatives clearing organization that is either registered with the Commission as a derivatives clearing organization or exempt from registration. Section 5b(h) of the CEA allows the Commission to exempt, conditionally or unconditionally, a DCO from registration for the clearing of swaps, where the DCO is subject to "comparable, comprehensive supervision and regulation" by the appropriate government authorities in its home country. The Commission has granted, by order, relief from registration to derivatives clearing organizations pursuant to section 5b(h)[22] and is considering whether to grant relief to other derivatives clearing organizations before the implementation date of these rules. Accordingly, the Commission is excluding from the definition of uncleared swap, those swaps that are cleared by a derivatives clearing organization that is either registered with or has received an exemption by order or rule from registration.

C. Participants

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[22] See In the Matter of the Petition of ASX Clear (Futures) Pty Limited for Exemption from Registration as a Derivatives Clearing Organization (Aug. 18, 2015); In the Matter of the Petition of Japan Securities Clearing Corporation (JSCC) for Exemption from Registration as a Derivatives Clearing Organization (Oct 26, 2015); In the Matter of the Petition of Korea Exchange, Inc (KRX) for Exemption from Registration as a Derivatives Clearing Organization (Oct. 26, 2015).

1. Proposal

Section 4s(e)(3)(A)(2) states that the margin requirements must be "appropriate to the risks associated with" the swaps. Because different types of counterparties can pose different levels of risk, the proposed rules established three categories of counterparty: (i)SDs and MSPs, (ii) financial end users,[23] and (iii) non-financial end users.[24] The nature of an SD/MSP's obligations under the rules differed depending on the nature of the counterparty.

2. Comments

Commenters generally urged the Commission to exclude certain entities from the definition of "financial end user." For example, commenters urged the Commission to exclude foreign funds[25] and employee benefit plans such as pension plans,[26] structured finance special purpose vehicles,[27] certain captive finance units,[28] entities guaranteed by a foreign sovereign,[29] small financial institutions (such as small banks) that qualify for an

[23] This term is defined in Regulation 23.151.
[24] This term is defined in Regulation 23.151 to include entities that are not SDs, MSPs, or financial entities.
[25] See ISDA (contending that it will be difficult for a non-U.S. entity to determine which Investment Company Act exemption would apply if it were organized in the U.S.).
[26] See ABA (pension plans should not be subject to margin and should be treated as non-financial end users); AIMA (benefit plans should not be subject to margin and there is ambiguity involving whether non-U.S. public and private employee benefit plans would be financial end users); JBA (securities investment funds should be exempt from variation margin).
[27] See ISDA (structured finance vehicles should be excluded because they do not pose systemic risk, have credit support arrangements to protect counterparties, and lack ready access to liquid collateral for initial and variation margin), JBA (securities investment funds and securitization vehicles are not set up to exchange variation margin and should be treated as non-financial end users), JFMC, Sifma-AMG, SFIG, and Sifma. See also FSR (the Commission should explore conditions to minimize risk rather than impose variation margin). See SFIG and Sifma (requesting the Commission to exclude structured finance vehicles from the payment of variation margin).
[28] See CDEU (wholly owned centralized treasury units of non-financial end users that execute swaps on behalf of those non-financial end users should not be treated as financial end users for margin purposes).
[29] See KfW and ICO (entities backed by the full faith and credit and irrevocable guarantee of a sovereign nation should be either within the definition of a sovereign entity or excluded from the definition of a financial end user and hence not subject to margin requirements). See also FMS-WM (legacy portfolio entity backed by the full faith and credit of a sovereign government should be included in the definition of a sovereign).

exemption from clearing,[30] certain financial cooperatives,[31] covered bond issuers,[32] and multilateral banks (e.g., International Monetary Fund and World Bank Group).[33] Commenters also urged the Commission to exclude from margin requirements certain other entities that are exempt from clearing.[34] One commenter also supported the exclusion of certain payment card networks and payment solution providers from the definition of a "financial end user."[35]

Commenters pointed out that the exclusion from financial end user for a person that qualifies for the affiliate exemption from clearing pursuant to section 2(h)(7)(D) of the Commodity Exchange Act requires an entity to be acting *as agent* for an affiliate and thus would not capture equivalent entities that act *as principal* for an affiliate.[36] These commenters contended that many such entities act as principal for an affiliate and that the

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[30] See ABA (small banks that qualify for the clearing exemption should be excluded from margin requirements as subjecting them to margin requirements would incentivize them to clear their trades while imposing monitoring costs on them to ensure that they do not have material swaps exposure).

[31] See CFC.

[32] See ISDA (arguing that the EU proposal has special criteria for covered bond issuers and that covered bond issuers should be able to use collateral arrangements other than the requirements in the Commission's proposal).

[33] See Sifma (the Commission should align the definition of multilateral banks in the margin regulations to the definition in the clearing exemption and specify that the United Nations and International Monetary Fund are included among multilateral banks) and MFX (MFX contends that it, as a fund, should be considered a multilateral development bank because the U.S. government is a shareholder through the Overseas Private Investment Corporation's involvement in the fund, the fund poses a similar risk profile as that of a multilateral development bank, and the fund engages in the same types of activities as a multilateral development bank).

[34] See W&C (initial and variation margin should not apply to an eligible treasury affiliate as defined in Commission No-Action Letter No. 13-22); ABA; CFC (entities that are exempt from clearing such as exempt cooperatives should be exempt from margin requirements); and CDEU (special purpose vehicles that are subsidiaries of captive finance companies that are exempt from clearing should be exempt from margin). But see AFR (cautioning against the scope of the exemption provided to non-financial end users in the proposal and urging the Commission to separate the clearing and margin exemptions).

[35] See MasterCard.

[36] See CEWG; Sifma; W&C.

Commission has issued a no-action letter effectively exempting such entities from clearing.[37]

With respect to employee benefit plans, commenters generally argued that these plans should not be subject to margin requirements because they are highly regulated, highly creditworthy, have low leverage and are prudently managed counterparties whose swaps are used primarily for hedging and, as such, pose little risk to their counterparties or the broader financial system. One commenter urged the Commission to exclude both U.S. and non-U.S. public and private employee benefit plans where swaps are hedging risk. This commenter also contended that there may be ambiguity whether certain pension plans are financial end users if they are not subject to the Employee Retirement Income and Security Act of 1974 ("ERISA") (29 U.S.C. 1002). Another commenter argued that current market practice is not to require initial margin for pension plans.

A number of commenters also requested that the Commission exclude from financial end user structured finance vehicles including securitization special purpose vehicles ("SPVs") and covered bond issuers. These commenters argued that imposing margin requirements on structured finance vehicles would restrict their ability to hedge interest rate and currency risk and potentially force these vehicles to exit swap markets since these vehicles generally do not have ready access to liquid collateral. These commenters contended that it is impossible for the vast majority of these entities to exchange margin, including variation margin, and that subjecting them to margin requirements would severely restrict the ability of securitization vehicles to hedge interest rate risk and currency risk.

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[37] See CFTC No-Action Letter No. 13-22 (June 4, 2013).

Moreover, commenters argued that covered swap entities, as defined below, that enter a swap may be protected by other means – e.g., a security interest granted in the assets of a securitization SPV. Commenters also noted that these types of entities make payments on a monthly payment cycle using collections received on the underlying assets during the previous month and would not be able to make daily margin calls. These commenters argued that significant structural changes would be necessary for securitization vehicles to post and collect variation margin.

These commenters urged the Commission to follow the approach of the proposed European rules under which securitization vehicles would be defined as non-financial entities and would not be required to exchange initial or variation margin. Certain of these commenters also expressed concerns about consistency with the treatment under the EU proposal. One commenter stated that the EU proposal has special criteria for covered bond issuers and that covered bond issuers should be able to use collateral arrangements other than the requirements in the Commission's proposal. Commenters similarly urged the Commission to follow the EU margin proposal which provided a special set of criteria for covered bond issuers and requested that the Commission develop rules that would permit covered bond issuers to use other forms of collateral arrangements. One commenter, however, argued that requiring SPVs and other asset-backed security issuers to post full margin against all swap contracts would defuse commonly used "flip clauses" and decrease the loss exposure of investors in asset-backed securities.[38]

A few commenters urged the Commission to remove a provision in the proposal allowing the Commission to designate entities as financial end users due to concerns that

[38] See William J. Harrington.

it would allow the Commission to re-categorize nonfinancial entities as financial end users.[39] These commenters argued that in order for an entity to be treated as a financial end user, the Commission would have to provide adequate notice and propose an amendment to the rule to address such concerns.[40]

Commenters also pointed out miscellaneous concerns with the proposal. They have asked for clarification with respect to the process for determining whether an entity is a financial end user,[41] suggested that the change in status of a counterparty over the life of a swap should not affect the classification of the counterparty,[42] and urged the Commission to align its definition of "financial end user" with the definition put forth by the Prudential Regulators regarding business development companies.[43] With respect to foreign counterparties, a few commenters argued that the test in the proposal concerning whether a foreign counterparty would be a financial end user if it were organized under the laws of the U.S. or any State is difficult to apply because it would require a covered swap entity to analyze a foreign counterparty's business activities in light of a broad array of U.S. regulatory requirements.[44] Finally, a commenter commended the Commission on its definition of financial end user.[45]

3. Discussion

[39] See CDEU; Joint Associations; IECA.
[40] See CDEU.
[41] See CDEU.
[42] See ISDA and Sifma.
[43] See JBA.
[44] See ISDA (contending that it will be difficult for a non-U.S. entity to determine which Investment Company Act exemption would apply if it were organized in the U.S.); see also AIMA (arguing that there is ambiguity regarding whether non-U.S. public and private pension plans would be treated as financial end users).
[45] See MasterCard (the definition in the margin regulations is commendable because it is narrower than the definition in Commission Regulation 50.50. Entities that engage in financial activities within the meaning of Section 4(k) of the Bank Holding Company Act that are not a financial end user should be allowed to rely on the end user exception).

(a). Covered Swap Entities

As noted above, section 4s(e)(2)(B) of the CEA directs the Commission to impose margin requirements on SDs and MSPs for which there is no Prudential Regulator. These entities are defined in proposed § 23.151 as "covered swap entities" or "CSEs." The final rule adopts the definition as set forth in the proposal. The final rule also includes special provisions for inter-affiliate swaps between a CSE and its affiliates. The following sections provide a discussion of other significant market participants and applicable standards set forth in the final rule.

(b). Financial End Users

(i) Definition

In order to provide certainty and clarity to counterparties as to whether they would be financial end users for purposes of this final rule, the financial end user definition provides a list of entities that would be financial end users as well as a list of entities excluded from the definition. In the final rule, as under the proposed rule, the Commission is relying, to the greatest extent possible, on the counterparty's legal status as a regulated financial entity. The definition lists numerous entities whose business is financial in nature.

In developing the definition, the Commission sought to provide clarity to CSEs and their counterparties about whether particular counterparties would be financial end users and subject to the margin requirements of the final rule. The definition is an attempt to capture all financial counterparties without being overly broad and capturing commercial firms and sovereigns.

The Commission believes that this approach is consistent with the risk-based approach of the final rule, as financial firms generally present a higher level of risk than other types of counterparties because their profitability and viability are more tightly linked to the health of the financial system than other types of counterparties. Because financial counterparties are more likely to default during a period of financial stress, they pose greater systemic risk and risk to the safety and soundness of the CSE.

In developing the list of financial entities, the Commission sought to include entities that engage in financial activities that give rise to Federal or State registration or chartering requirements, such as deposit taking and lending, securities and swaps dealing, or investment advisory activities.

The Commission notes that an entity or person would be classified as a financial end user based on the nature of the activities of that entity or person regardless of the source of the funds used to finance such activities. For example, an entity or person would be a financial entity if it raises money from investors, uses its own funds, or accepts money from clients or customers to predominately engage in investing, dealing, or trading in loans, securities, or swaps.

The list also includes asset management and securitization entities. For example, certain investment funds as well as securitization vehicles are covered, to the extent those entities would qualify as private funds defined in section 202(a) of the Investment Advisers Act of 1940, as amended (the “Advisers Act”). In addition, certain real estate investment companies would be included as financial end users as entities that would be investment companies under section 3 of the Investment Company Act of 1940, as amended (the “Investment Company Act”), but for section 3(c)(5)(C), and certain other securitization vehicles would be included as entities deemed not to be investment companies pursuant to Rule 3a-7 of the Investment Company Act.

Because Federal law largely looks to the States for the regulation of the business of insurance, the definition of financial end user in the final rule broadly includes entities organized as insurance companies or supervised as such by a State insurance regulator. This element of the final rule's definition would extend to reinsurance and monoline insurance firms, as well as insurance firms supervised by a foreign insurance regulator.

The Commission intends to cover, as financial end users, a broad variety and number of nonbank lending and retail payment firms that operate in the market. To this end, the Commission has included State-licensed or registered credit or lending entities and money services businesses under the final rule's provision incorporating an inclusive list of the types of firms subject to State law. However, the Commission recognizes that the licensing of nonbank lenders in some states extends to commercial firms that provide credit to the firm's customers in the ordinary course of business. Accordingly, the Commission is excluding an entity registered or licensed solely on account of financing the entity's direct sales of goods or services to customers.

Under the final rule, those cooperatives that are financial institutions,[46] such as credit unions, Farm Credit System banks and associations,[47] and other financial

[46] The Commission expects that state-chartered financial cooperatives that provide financial services to their members, such as lending to their members and entering into swaps in connection with those loans, would be treated as financial end users, pursuant to this aspect of the final rule's coverage of credit or lending entities. However, these cooperatives could elect an exemption from clearing under regulation 50.51, 17 CFR § 50.51, and as a result, their uncleared swaps would also be exempt from the margin requirements of the final rule pursuant to Regulation 23.150(b).

[47] The preamble more fully discusses the status of Farm Credit System institutions as financial end users and their exemptions from clearing and the margin requirements.

cooperatives[48] are financial end users because their sole business is lending and providing other financial services to their members, including engaging in swaps in connection with such loans.[49] The treatment of the uncleared swaps of these financial cooperatives may differ under the final rule due to TRIPRA, which became law after the proposal was issued. More specifically, almost all swaps of the cooperatives that are financial end users qualify for an exemption from clearing if certain conditions are met,[50] and therefore, these uncleared swaps also would qualify for an exemption from margin requirements under § 23.150(b) of the final rule. Uncleared swaps of financial cooperatives that do not qualify for an exemption would be treated as uncleared swaps of financial end users under the final rule.

The final rule's definition of "financial end user" is largely similar to the proposed definition, with a few modifications. In the final rule, the Commission added as a financial end user a U.S. intermediate holding company ("IHC") established or designated for purposes of compliance with the Board's Regulation YY (12 CFR 252.153). Pursuant to Regulation YY, a foreign banking organization with U.S. non-

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[48] The National Rural Utility Cooperative Finance Cooperation ("CFC") is an example of another financial cooperative. The CFC's comment letter requested that the Commission exempt swaps entered into by nonprofit cooperatives from the margin requirement to the extent they that are already exempt from clearing requirements. Regulation 23.150(b) of the final rule responds to the CFC's concerns.

[49] Most cooperatives are producer, consumer, or supply cooperatives and, therefore, they are not financial end users. However, many of these cooperatives have financing subsidiaries and affiliates. These financing subsidiaries and affiliates would not be financial end users under this final rule if they qualify for an exemption under sections 2(h)(7)(C)(iii) or 2(h)(7)(D) of the CEA. Moreover, certain swaps of these entities may be exempt pursuant to TRIRA and Regulation 23.150(b) of the final rule.

[50] Section 2(h)(7)(C)(ii) of the CEA authorizes the Commission to exempt small depository institutions, small Farm Credit System institutions, and small credit unions with total assets of $10 billion or less from the mandatory clearing requirements for swaps. See 7 U.S.C. 2(h)(7) and 15 U.S.C. 78c-3(g). Additionally, the Commission, pursuant to its authority under section 4(c)(1) of the CEA, enacted 17 CFR part 50, subpart C, section 50.51, which allows cooperative financial entities, including those with total assets in excess of $10 billion, to elect an exemption from mandatory clearing of swaps that: (1) they enter into in connection with originating loans for their members; or (2) hedge or mitigate commercial risk related to loans or swaps with their members.

branch assets of $50 billion or more must establish a U.S. IHC and transfer its ownership interest in the majority of its U.S. subsidiaries to the IHC by July 1, 2016. As not all IHCs will be bank holding companies, the Commission is explicitly identifying IHCs in the list of financial end users to clarify that they are included. To the extent an IHC that is not itself registered as a swap entity enters into uncleared swaps with a CSE, the IHC would be treated as a financial end user like other types of holding companies that are not swap entities (e.g., bank holding companies and saving and loan holding companies).

In response to the commenters request to align its definition of financial end user with the Prudential Regulators' definition, the Commission also added business development companies in subparagraph (vi) of the definition of financial end user.

The Commission also has added three entities registered with the Commission to the enumerated list of financial end users: floor brokers, floor traders, and introducing brokers. As defined in section 1a(22) of the CEA, a floor broker generally provides brokering services on an exchange to clients in purchasing or selling any future, securities future, swap, or commodity option. As defined in section 1a(23) of the CEA, a floor trader generally purchases or sells on an exchange solely for that person's account, any future, securities future, swap, or commodity option. As defined in section 1a(31) of the CEA, an introducing broker generally means any person who engages in soliciting or in accepting orders for the purchase and sale of any future, security future, commodity option, or swap. In addition, it also includes anyone that is registered with the Commission as an introducing broker.

In deciding to add these entities to the definition of financial end user, the Commission determined that these entities' services and activities are financial in nature and that these entities provide services, engage in activities, or have sources of income that are similar to financial entities already included in the definition. In this vein, the Commission is also adding to the list of financial end user security-based swap dealers and major security-based swap participants. The Commission believes that by including these financial entities in the definition of financial end user, the definition provides additional clarity to CSEs when engaging in uncleared swaps with these entities. As noted above, financial entities are considered more systemic than non-financial entities and as such, the Commission believes that these entities, whose activities, services, and sources of income are financial in nature, should be included in the definition of financial end user. The Commission notes, however, that if a commercial end user falls within the definition of financial end user under this rule because of, for example, its registration as a floor broker or otherwise, so long as its swaps qualify for an exemption under TRIPRA, those swaps will not be subject to the margin requirements of these rules.

In the proposal, the Commission included in the definition of a financial end user "An entity that is, or holds itself out as being, an entity or arrangement that raises money from investors primarily for the purpose 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." In addition to asking whether the definition was too broad or narrow, as noted above, the Commission asked questions as to whether this prong of the definition was broad enough to capture other types of pooled investment vehicles that should be treated as financial end users.

After reviewing all comments, the Commission is broadening section (xi) of the definition of a "financial end user" to include other types of entities and persons that primarily engage in trading, investing, or in facilitating the trading or investing in loans, securities, swaps, funds, or other assets. In broadening the definition, the Commission believes that the enumerated list in the proposal of financial end users was under-inclusive, not covering certain entities that provide or engage in services and activities that are financial in nature. Specifically, the Commission is concerned that the proposed definition did not cover certain financial entities that are not organized as pooled investment vehicles and that trade or invest their own or client funds (e.g., high frequency trading firms) or that provide other financial services to their clients. The Commission's approach also addresses concerns, now or in the future, that one or more types of financial entities might escape classification under the specific Federal or State regulatory regimes included in the definition of "financial end user."

In order to address concerns raised by commenters, the final rule removes the provision in the definition of "financial end user" that included any other entity that the Commission has determined should be treated as a financial end user. The Commission will monitor the margin arrangements of swap transactions of CSEs to determine if certain types of counterparties, in fact, are financial entities that are not covered by the definition of "financial end user" in the final rule. In the event that the Commission finds that one or more types of financial entities escape classification as financial end users under the final rule, the Commission may consider another rulemaking that would amend the definition of "financial end user" so it covers such entities.

In the proposal, the Commission stated that "[f]inancial firms present a higher level of risk than other types of counterparties because the profitability and viability of financial firms is more tightly linked to the health of the financial system than other types of counterparties."[51] Accordingly, it is crucial that the definition of financial end user include the types of firms that engage in the activities described above.

Many of the provisions in the financial end user definitions rely on whether an entity's financial activities trigger Federal or State registration or chartering requirements. In its proposal, the Commission included in the definition of "financial end user" any entity that would be a financial end user if it were organized under the laws of the United States or any State. A few commenters argued that the proposed test is difficult to apply because it would require a CSE to analyze a foreign counterparty's business activities in light of a broad array of U.S. regulatory requirements.

The Commission has not modified this provision in the final rule. The Commission acknowledges that the test imposes a greater incremental burden in classifying foreign counterparties than it does in identifying U.S. financial end users. The burdens associated with classifying counterparties as financial or non-financial has been a recurring theme during the rulemaking. To reduce the burden, in this instance, the Commission believes that CSEs may rely on good faith representations from their counterparties as to whether they are financial end users under the final rule. The Commission believes the approach in the final rule captures the kinds of entities whose profitability and viability are most tightly linked to the health of the financial system.

In this respect, the Commission's financial end user definition is broad by design. Exclusion from the financial end user definition for any enterprise engaged extensively in financial and market activities should, as a practical matter, be the exception rather than the rule. The Commission believes it is appropriate to require a CSE that seeks to

[51] 79 FR at 57360 (September 24, 2014).

exclude a foreign financial enterprise from the rule's margin requirements to ascertain the basis for that exclusion under the same laws that apply to U.S. entities.

The Commission has included in the final rule not only an entity that is or would be a financial end user but also an entity that is or would be a swap entity, if it were organized under the laws of the United States or any State. Since a financial end user is defined as "a counterparty that is not a swap entity," the purpose of this addition is to make clear that an entity that is not a registered swap entity in the U.S. but acts as a swap entity in a foreign jurisdiction would be treated as a financial end user under the final rule.

As noted above, the Commission believes that financial firms present a higher level of risk than other types of counterparties because the profitability and viability of financial firms is more tightly linked to the health of the financial system than other types of counterparties. Accordingly, the Commission has adopted a definition of financial end user that includes the types of firms that engage in the activities described above.

The final rule, like the proposal, excludes certain types of counterparties from the definition of financial end user. The definition of financial entities[52] excludes the government of any country, central banks, multilateral development banks,[53] the Bank for International Settlements, captive finance companies,[54] and agent affiliates.[55] The

[52] Regulation 23.151.
[53] Some commenters requested additional clarity that certain entities would be included as multilateral development banks. See SIFMA; MFX. The definition in the final rule includes an enumerated list of entities in addition to any other entity that provides financing for national or regional development in which the U.S. government is a shareholder or contributing member or which the relevant Agency determines poses comparable credit risk. Entities that meet this part of the definition would be treated as multilateral development banks for purposes of the final rule.
[54] A captive finance company is an entity that is excluded from the definition of financial entity under section 2(h)(7)(c)(iii) of the CEA for purposes of the requirement to submit certain swaps for clearing. That section describes it as "an entity whose primary business is providing financing, and uses derivatives

exclusion for sovereign entities, multilateral development banks and the Bank for International Settlements is consistent with the 2013 international framework and the definition of the Prudential Regulators.[56]

The Commission believes that this approach is appropriate as these entities generally pose less systemic risk to the financial system as their activities generally have a different purpose in the financial system leading to a lower risk profile in addition to posing less counterparty risk to a swap entity. Thus, the Commission believes that application of the margin requirements that would apply for financial end users to swaps with these counterparties is not necessary to achieve the objectives of this rule.

The Commission notes that States would not be excluded from the definition of financial end user, as the term "sovereign entity" includes only central governments. This does not mean, however, that States are categorically classified as financial end users. Whether a State or particular part of a State (e.g., counties, municipalities, special administrative districts, agencies, instrumentalities, or corporations) would be a financial end user depends on whether that part of the State is otherwise captured by the definition of financial end user. For example, a State entity that is a "governmental plan" under ERISA would meet the definition of financial end user.

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for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 90 percent or more of which arise from financing that facilitates the purchase or lease of products, 90 percent or more of which are manufactured by the parent company or another subsidiary of the parent company."

[55] An agent affiliate is an entity that is an affiliate of a person that qualifies for an exception from the requirement to submit certain trades for clearing. Under section 2(h)(7)(D) of the CEA, "an affiliate of a person that qualifies for an exception under subparagraph (A) (including affiliate entities predominantly engaged in providing financing for the purchase of the merchandise or manufactured goods of the person) may qualify for the exception only if the affiliate, acting on behalf of the person and as an agent, uses the swap to hedge or mitigate the commercial risk of the person or other affiliate of the person that is not a financial entity."

[56] As discussed below, captive finance companies and agent affiliates are excluded by TRIPRA from the definition of financial entity.

As noted above, commenters requested that the Commission exclude a number of other entities from the definition of financial end user including small banks that qualify for an exception from clearing,[57] certain financial cooperatives,[58] pension plans,[59] structured finance vehicles,[60] and covered bond issuers.[61] Depository institutions, financial cooperatives, employee benefit plans, structured finance vehicles, and covered bond issuers are financial end users for purposes of the final rule. The interim final rule addresses the comments raised regarding the uncleared swaps of small banks and certain financial cooperatives by providing an exemption for such swaps that qualify for an exemption from clearing. The uncleared swaps of small banks or financial cooperatives that do not qualify for the exemptive treatment would be treated as swaps of financial end users under the final rule.

The Commission has not modified the definition of financial end user to exclude pension plans, structured finance vehicles, or covered bonds issuers.

Congress explicitly listed an employee benefit plan as defined in paragraph (3) and (32) of section 3 of the ERISA in the definition of "financial entity" in the Dodd-Frank Act, meaning that a pension plan would not benefit from an exclusion from clearing even if the pension plan used swaps to hedge or mitigate commercial risk. The

[57] See ABA.
[58] See CFC.
[59] See ABA; AIMA. These commenters generally argued that pension plans should not be subject to margin requirements because they are highly regulated, highly creditworthy, have low leveraged and are prudently managed counterparties whose swaps are used primarily for hedging and, as such, pose little risk to their counterparties or the broader financial system.
[60] See FSR; ISDA; JBA; JFMC; SIFMA AMG; SFIG. Commenters argued that imposing margin requirements on structured finance vehicles would restrict their ability to hedge interest rate and currency risk and potentially force these vehicles to exit swaps markets since these vehicles generally do not have ready access to liquid collateral. Certain of these commenters also expressed concerns about consistency with the treatment under the EU proposal.
[61] See ISDA (arguing that the EU proposal has special criteria for covered bond issuers and that covered bond issuers should be able to use collateral arrangements other than the requirements in the Commission's proposal).

Commission believes that, similarly, when a pension plan enters into an uncleared swap with a CSE, the pension plan should be treated as a financial end user and subject to the requirements of the final rule.

The definition of employee benefit plan in the final rule is the same as in the proposal and is defined by reference to paragraphs (3) and (32) of the ERISA. Paragraph (3) provides that the term “employee benefit plan” or “plan” means an employee welfare benefit plan or an employee pension benefit plan or a plan which is both an employee welfare benefit plan and an employee pension benefit plan. Paragraph (32) describes certain governmental plans. In response to concerns raised by commenters, the Commission believes that these broad definitions would cover all pension plans regardless of whether the pension plan is subject to the ERISA. In addition, non-U.S. employee benefit plans would be included as an entity that would be a financial end user, if it were organized under the laws of the United States or any State thereof.

The Commission believes that all of these entities should qualify as financial end users; their financial and market activities comprise the same range of activities as the other entities encompassed by the final rule’s definition of financial end user. The Commission notes that the increase in the size of positions necessary to constitute material swaps exposure in the final rule should address some of the concerns raised by these commenters with respect to the applicability of initial margin requirements.

(ii). Small Banks

As noted above, banks would be financial end users under the final rule. They would be subject to initial margin requirements if they entered into uncleared swaps with CSEs and, as discussed below, had material swaps exposure. However, TRIPRA also excluded certain swaps with small banks from the margin requirements of this rule. In particular, section 2(h)(7)(A) of the Commodity Exchange Act excepts from clearing any swap where one of the counterparties is not a financial entity, is using the swap to hedge or mitigate commercial risk, and notifies the Commission how it generally meets its financial obligations associated with entering into uncleared swaps.[62] As authorized by the Dodd-Frank Act, the Commission has excluded depository institutions, Farm Credit System Institutions, and credit unions with total assets of $10 billion or less, from the definition of "financial entity," thereby permitting those institutions to avail themselves of the clearing exception for end users.[63] Uncleared swaps with those entities would be eligible for the TRIPRA exemption in the Commission's margin rules, provided they meet other requirements for the clearing exception. As a consequence of TRIPRA, if a small bank with total assets of $10 billion or less enters into a swap with a CSE that meets the requirements of the exception from clearing, that swap will not be subject to the margin requirements of these rules.

When a bank with total assets greater than $10 billion enters into a swap with a CSE, the CSE will be required to post and collect initial margin pursuant to the rule only if the bank had a material swaps exposure and is not otherwise exempt.[64] The final rule requires a CSE to exchange daily variation margin with a bank with total assets above

[62] A "financial entity" is defined to mean (i) a swap dealer; (ii) a security-based swap dealer; (iii) a major swap participant; (iv) a major security-based swap participant; (v) a commodity pool; (vi) a private fund as defined in section 202(a) of the Investment Advisers Act of 1940; (vii) an employee benefit plan as defined in sections 3(3) and 3(32) of the Employment Retirement Income Security Act of 1974; (viii) a person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature, as defined in section 4(k) of the Bank Holding Company Act of 1956. See 7 U.S.C. 2(h)(7)(C)(i).
[63] See 7 U.S.C. 2(h)(7)(C)(ii) and 77 FR 42560 (July 19, 2012); 77 FR 20536 (April 5, 2012).
[64] The final rule defines material swaps exposure as an average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange forwards and foreign exchange swaps with all counterparties for June, July, and August of the previous calendar year that exceeds $8 billion, where such amount is calculated only for business days.

$10 billion, regardless of whether the bank has material swaps exposure. However, the CSE will only be required to collect variation margin from a bank when the amount of both initial margin and variation margin required to be collected exceeds the minimum transfer amount of $500,000.

(iii). Multilateral Development Banks

The proposed definition of the term "multilateral development bank," includes a provision encompassing "[a]ny other entity that provides financing for national or regional development in which the U.S. government is a shareholder or contributing member or which the Commission determines poses comparable credit risk."

As described above, the final rule excludes from the definition of financial end user a "sovereign entity" defined to mean a central government (including the U.S. government) or an agency, department, or central bank of a central government. An entity guaranteed by a sovereign entity is not explicitly excluded from the definition of financial end user in the final rule, unless that entity qualifies as a central government agency, department, or central bank. The existence of a government guarantee does not in and of itself exclude the entity from the definition of financial end user.

(iv). Material Swaps Exposure

The Commission proposed a "material swaps exposure" level of $3 billion. This threshold is lower than the guidelines contained in WGMR and also in the EU's consultation paper. The Commission proposed a lower threshold based on data it analyzed concerning the required margin on cleared swaps.

A number of commenters argued that the Commission should raise the level of material swaps exposure to the threshold of €8 billion set out in the 2013 international framework to be consistent with the EU and Japanese proposals.[65] A commenter suggested that adopting different exposure levels may result in the failure of an international framework.[66] Commenters suggested that the Commission conduct further studies on the uncleared swaps markets before adopting a threshold.[67] Some commenters expressed the view that the international implementation of material swaps exposure threshold treats the threshold more as a scope provision, to define the group of financial firms in the swaps market whose activities rise to a level appropriate to the exchange of initial margin as a policy matter.[68]

Commenters representing public interest groups and CCPs expressed policy concerns about whether the $3 billion threshold was conservative enough, focusing on the collective systemic risk posed by all smaller counterparties in the aggregate. Other commenters representing CSEs and financial end users expressed concerns about the additional initial margin they would be required to exchange compared to foreign firms, and the associated competitive impacts.

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[65] See ABA; AIMA; CEWG, CPFM; CCMR; FHLB; FSR; GPC; IFM, ISDA; ICI; IIB; JBA; MFA: Sifma AMG; Sifma; Shell TRM; NERA; and Vanguard. By contrast, one commenter suggested reducing the threshold below $3 billion. CME. Another commenter expressed concerns that entities below $3 billion could have considerable exposures. AFR. One commenter cautioned against the aggressive use of thresholds to manage liquidity. Barnard.

[66] See JBA (financial institutions will abide by different rules depending on their counterparties' jurisdiction).; see also MFA (competitive discrepancies may result).

[67] See IFM; Sifma; ABA. See also ISDA (Commission's calculations assume that a covered swap counterparty has all its swaps with one party).

[68] For example, one commenter acknowledged data described by the Commission in the proposed rule indicating that bilateral initial margin exposures between one CSE and a financial end user could exceed $50 million for a portfolio with a gross notional value well below the USD-equivalent of the international €8 billion threshold. But the commenter urged the Commission to shift its focus from the $65 million amount, as a bilateral constraint, and recognize that a financial end user will often use multiple dealers. Accordingly, the commenter urged the Commission to treat the material swaps exposure threshold as a focus on a financial end user's multilateral exposures with all its dealers, which provides the rationale for the higher international threshold.

Commenters also commented on the method for calculating material swaps exposure. A few commenters suggested that a daily aggregate notional measure was burdensome and the Commission should use a month-end notional amount like the EU proposal and consistent with the international framework.[69] Commenters urged the Commission to make clear that inter-affiliate swaps would not be included for purposes of determining the material swaps exposure.[70] Certain of these commenters also argued that the proposal could require an entity to double-count inter-affiliate swaps in assessing material swaps exposure.

Commenters also argued that certain other swaps should not be counted for purposes of the material swaps exposure calculation. A few commenters argued that foreign exchange swaps and foreign exchange forwards that are exempt from the definition of swap by Treasury determination should not be included for purposes of determining material swaps exposure.[71] Other commenters argued that hedging positions should not be counted toward material swaps exposure.[72] A commenter argued that the material swaps exposure calculation should not include swaps of all affiliates of a financial end user.[73]

A few commenters urged the Commission to make clear that a CSE may rely on representations of its counterparties in assessing whether it is transacting with a financial

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[69] See JBA; Sifma.
[70] See ABA; CEWG; CDEU; FSR; GPC; ICI; ISDA: Sifma AMG; Sifma; Shell TRM; Vanguard.
[71] See ICI; ABA; ISDA; GPC; Sifma; Sifma AMG; Vanguard. The final rule defines "foreign exchange forward and foreign exchange swap" to mean any foreign exchange forward, as that term is defined in section 1a(24) of the Commodity Exchange Act (7 U.S.C. 1a(24)), and foreign exchange swap, as that term is defined in section 1a(25) of the Commodity Exchange Act (7 U.S.C. 1a(25)). See Regulation 23.151.
[72] See GPC; CFC.
[73] See CDEU (many non-financial end users have financial end users as affiliates, and certain of their swaps should be excluded).

end user with material swaps exposure.[74] One commenter urged the Commission to clarify what happens when a financial end user counterparty that had a material swaps exposure falls below the threshold.[75]

The final rule increases the level of the aggregate notional amount of transactions that gives rise to material swaps exposure to $8 billion. The material swaps exposure threshold of $8 billion in the final rule is broadly consistent with the €8 billion established by the 2013 international framework and the EU and Japanese proposals. In the proposal, the Commission had calibrated the proposed $3 billion threshold to the size of a potential swap portfolio between a CSE and a financial end user for which the initial margin amount would often exceed the proposed initial margin threshold amount of $65 million, reducing the burden of calculating initial margin amounts for smaller portfolios.

The material swaps exposure threshold of $8 billion in the final rule has been calibrated relative to the €8 billion established by the 2013 international framework in the manner described below. At this time, the Commission believes the better course is to calibrate the final rule's material swaps exposure threshold to the higher 2013 international framework amount, in recognition of each financial end user's overall potential future swaps exposure to the market rather than its potential future exposure to one dealer. In this regard, the Commission notes that variation margin will still be exchanged without any threshold, and further that the $8 billion threshold may warrant further discussion among international regulators in future years, if implementation of the threshold proves to create concerns about market coverage for initial margin.

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[74] See ABA; FHLB: IFM; ISDA; BP; Shell TRM; CEWG; see also GPC; SIFMA.
[75] See FHLB.

In the final rule, "material swaps exposure" for an entity means that an entity and its affiliates have an average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange forwards, and foreign exchange swaps with all counterparties for June, July, and August of the previous calendar year that exceeds $8 billion, where such amount is calculated only for business days.[76] The final rule's definition also provides that an entity shall count the average daily aggregate notional amount of an uncleared swap, an uncleared security-based swap, a foreign exchange forward or a foreign exchange swap between the entity and an affiliate only one time. In addition, as discussed below, the calculation does not include a swap or security-based swap that is exempt pursuant to TRIPRA.

The time period for measuring material swaps exposure is June, July and August of the previous calendar year under the final rule, the same period as under the proposal. The Commission believes that using the average daily aggregate notional amount[77] during June, July, and August of the previous year, instead of a single as-of date, is appropriate to gather a more comprehensive assessment of the financial end user's participation in the swaps market, and to address the possibility that a market participant might "window dress" its exposure on an as-of date such as year-end, in order to avoid the Commissions' margin requirements. Material swaps exposure would be calculated based on the previous year. For example, for the period January 1, 2017 through

[76] The final rule also includes a new definition of "business day" that means any day other than a Saturday, Sunday, or legal holiday. This definition is described further below.

[77] A few commenters suggested that a daily aggregate notional measure was burdensome and that the Commission should use a month-end notional amount like the EU proposal and consistent with the international framework. JBA; SIFMA. The Commission has maintained the daily aggregate notional amount.

December 31, 2017, an entity would determine whether it had a material swaps exposure with reference to June, July, and August of 2016.[78]

The definition of material swaps exposure also contains a number of other changes from the proposed definition. Commenters urged the Commission to make clear that inter-affiliate swaps would not be included for purposes of determining the material swaps exposure.[79] Certain of these commenters also argued that the proposal could require an entity to double-count inter-affiliate swaps in assessing material swaps exposure.

In order to address concerns about double counting affiliate swaps, the final rule provides that an entity shall count the average daily aggregate notional amount of an uncleared swap, an uncleared security-based swap, a foreign exchange forward or a foreign exchange swap between the entity and an affiliate only one time.[80] The Commission also believes that the revised definition of affiliate in the final rule (described below) should help mitigate some of the concerns raised by commenters about the inclusion of an affiliate's swaps in determining material swaps exposure.[81]

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[78] As a specific example of the calculation for material swaps exposure, consider a financial end user (together with its affiliates) with a portfolio consisting of two uncleared swaps (e.g., an equity swap, an interest rate swap) and one uncleared security-based credit swap. Suppose that the notional value of each swap is exactly $10 billion on each business day of June, July, and August of 2016. Furthermore, suppose that a foreign exchange forward is added to the entity's portfolio at the end of the day on July 31, 2016, and that its notional value is $10 billion on every business day of August 2016. On each business day of June and July 2016, the aggregate notional amount of uncleared swaps, security-based swaps and foreign exchange forwards and swaps is $30 billion. Beginning on June 1, 2016, the aggregate notional amount of uncleared swaps, security-based swaps and foreign exchange forwards and swaps is $40 billion. The daily average aggregate notional value for June, July, August 2016 is then (22x$30 billion +23x$30 billion + 21x$40 billion)/(22+20+23)=$33.5 billion, in which case this entity would be considered to have a material swaps exposure for every date in 2017. .

[79] See ABA; WGCEF; FSR; GPC; ICI; ISDA: SIFMA AMG; SIFMA; Vanguard.

[80] The Commission made a similar change to the definition of "initial margin threshold amount" as described in Regulation 23.151.

[81] For example, the revised definition of "affiliate" generally would not treat investment funds that share an investment adviser or investment manager as affiliates.

The final rule's definition of material swaps exposure also states that for purposes of this calculation, an entity shall not count a swap that is exempt pursuant to § 23.150(b).[82] This change is consistent with the statutory exemptions provided by Congress in TRIPRA 2015 and ensures that exempt swaps do not count toward determining whether an entity has material swaps exposure.

As the material swaps exposure is designed to measure the overall derivatives exposure of an entity, the final rule's calculation of material swaps exposure continues to include foreign exchange swaps and foreign exchange forwards as well as swaps used to hedge. The final rule also does not make a distinction between uncleared swaps entered into prior to and after the effective dates for mandatory clearing. The Commission believes that the increase in the level of the material swaps exposure to $8 billion in the final rule should address many of the concerns raised by commenters about the inclusion of particular categories of swaps. Moreover, the material swaps exposure threshold is intended to identify entities that engage in significant derivatives activity in order to determine whether their swaps activity should be subject to initial margin requirements under the final rule.

The Commission believes the final rule's approach is appropriate in assessing a swap counterparty's overall size and risk exposure and providing for a simple and transparent measurement of exposure that presents only a modest operational burden. This approach also is intended to achieve consistency with other jurisdictions based on the 2013 international framework which sets a threshold based on overall gross notional

[82] The Commission made a similar change to the definition of "initial margin threshold amount" as described in Regulation 23.151.

non-centrally cleared derivatives activity. [83] Moreover, given that the Commission is viewing the final rule's material swaps exposure as an indicator of a financial end user's overall exposure in the market and revising the threshold upward to $8 billion, the Commission believes the inclusiveness of the calculation adopted in the final rule is appropriate.

Although the final rule does not explicitly provide how a CSE should determine if a financial end user counterparty has material swaps exposure, the Commission believes that it would be reasonable for a CSE to rely on good-faith representations of its counterparty in making such assessments.

One commenter urged the Commission to clarify what happens when a financial end user counterparty that had a material swaps exposure falls below the threshold. Because the material swaps exposure determination applies to a financial end user for an entire calendar year, depending on whether the financial end user exceeded the threshold during the third calendar quarter of the previous year, it is possible for a CSE to have a portfolio of swaps with a financial end user whose status under the material swaps exposure test changes from time to time. New section 23.161(c) of the final rule addresses this concern and explains what happens upon a change in counterparty status.

For example, if a financial end user is moving below the threshold for the upcoming calendar year, the CSE is not obligated under the final rule to exchange initial margin with that end user during that calendar year, either for new swaps entered into that

[83] One commenter urged the Commission to conform with the 2013 international framework where material swaps exposure is based on derivatives (not swaps). See ICI. Another commenter urged the Commission to exclude registered swap dealers from the material swaps exposure calculation as this could cause affiliates of the swap dealer to exceed the material swaps exposure threshold. See FSR. The final rule does not exclude registered swap dealers from the material swaps exposure threshold. The Commission believes that financial affiliates of a registered swap dealer should be treated as having a material swaps exposure based on their level of risk.

year or existing swaps from a prior year.   Any margin that had been previously collected while the counterparty had a material swaps exposure would not be required under the final rule for as long as the counterparty did not have a material swaps exposure.  In addition, a CSE's swaps with a financial end user without material swaps exposure would continue to be subject to the variation margin requirements of the final rule.

If a financial end user is moving above the threshold for the upcoming calendar year, the treatment of the existing swaps and the new swaps is the same as described for swaps before and after the rule's compliance implementation date.  As described in more detail below, the parties have the option to document the old and new swaps as separate portfolios for netting purposes under an eligible master netting agreement, and exchange initial margin only for the new portfolio of swaps entered into during the new calendar year after the financial end user triggered the material swaps exposure threshold determination.

(v).  Margin Affiliates and Margin Subsidiaries

The proposal defined an "affiliate" as any company that controls, is controlled by, or is under common control with another company.[84]  The proposal defined the control of another company generally as the ownership or power to vote 25% or more of any class of voting securities of another entity; or the ownership of 25% or more of the total equity in any entity; or the power to elect a majority of the directors or trustees of an entity.  An entity would be a subsidiary of another entity if it were controlled by that other entity.

Commenters raised a number of concerns with the proposal's definitions of "affiliate," "subsidiary" and "control."  While one commenter expressed support for the

[84] The Commission notes that under the proposal the Commission used the terms affiliate and subsidiary; however in its final rule, it is using the term "margin affiliate" and "margin subsidiary".

proposal's definition of control,[85] the vast majority of commenters argued for a modified definition of control that did not use the 25 percent threshold.[86] One commenter suggested that these terms should be defined by reference to whether an affiliate or subsidiary is consolidated under accounting standards.[87] A number of these commenters urged the Commission to use a majority ownership test (51 percent or more) for determining control.[88] Certain commenters expressed concern about the cross-border application of these definitions.[89]

Commenters also expressed particular concerns about the application of these definitions in the proposal to investment funds, including during the seeding period. A number of commenters urged the Commission to use the same criteria as the 2013 international framework as the basis for determining whether or not an investment fund is an affiliate of a fund sponsor.[90] Commenters also argued that seed capital contributed by a fund sponsor should not be viewed as control even if the ownership by the fund sponsor

[85] See Better Markets.
[86] See ACLI; FSR; CEWG; the GPC; IIB; ISDA; JBA; MFA; Sifma AMG; Sifma; Vanguard. (One commenter argued that the definitions of affiliate and control should not include relationships with or through the U.S. government and its representatives. See Freddie.)
[87] See ISDA.
[88] See ACLI; Commercial Energy Working Group; IIB; JBA; IFM; SIFMA AMG; SIFMA; TIAA-CREF; Vanguard. For example, one commenter argued that applying the initial margin threshold would be difficult with a 25 percent control test and it would be hard to agree on allocation of the threshold among the parties. ACLI.
[89] See CCMR; IIB; SIFMA AMG. For example, one commenter argued that a 50 percent ownership threshold would conform to the EU Proposal. See IIB.
[90] See AIMA; CCMR; ICI; SIFMA AMG; Vanguard; MFA. The 2013 international framework states that investment funds that are managed by an investment adviser are considered distinct entities that are treated separately when applying the threshold 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 investment adviser in the event of fund insolvency or bankruptcy. One commenter suggested an investment fund separateness to determine whether an investment fund is a separate legal entity. This commenter also urged the Commission to incorporate the concept of "effective control" as developed by the Financial Accounting Standards Board ("FASB") to cover variable interest entities and special purpose entities. See Better Markets.

exceeds 25 percent.[91] One commenter, for example, suggested that passive investors should be excluded even where they own more than 51 percent of the ownership interests.[92] A few commenters also suggested that registered funds may treat each separately managed "sleeve" of the fund as a separate registered fund.[93]

Commenters also expressed particular concerns about how the definitions applied to pension funds. One commenter argued that the sponsor of a pension should not be an affiliate of the pension fund by virtue of appointing trustees or directors of the pension fund.[94] This commenter urged that pension plans should not be deemed to have any affiliates other than those entities to whom a CSE counterparty has recourse for relevant pension trades. Other commenters argued that pension plans should be exempted from the definition of affiliate which could conflict with fiduciary obligations under ERISA.[95]

The term affiliate is used in the definition of initial margin threshold amount which means a credit exposure of $50 million that is applicable to uncleared swaps between a CSE and its affiliates with a counterparty and its affiliates. The inclusion of affiliates in this definition is meant to make clear that the initial margin threshold amount applies to an entity and its affiliates.

Similarly, the term "affiliate" is also used in the definition of "material swaps exposure," as material swaps exposure takes into account the exposures of an entity and

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[91] See ACLI; Sifma; Sifma AMG. One commenter also urged the Commission to clarify that independently controlled accounts are separate counterparties. See Sifma.
[92] See Sifma AMG.
[93] See ICI; Sifma AMG.
[94] See GPC (arguing this could foreclose pension plans from using third-party custodians).
[95] See FSR (arguing that how a swap entity allocates its initial margin threshold to the ERISA plan must be done in a way not to violate the fiduciary duty to the pension plan and that would requirement input from the Department of Labor).

its affiliates.  The term "affiliate" is also used for determining the compliance date for a CSE and its counterparty in § 23.161.

Using financial accounting as the trigger for affiliation, rather than a legal control test, should address many of the concerns raised by commenters.  In addition, the Commission believes that this approach reflects a more accurate method for discerning whether an entity has control over another entity.  Although consolidation tests under any other accounting standard that the entity may use must also be applied on a case-by-case basis, like the proposed rule's "control" test, the analysis has already been performed for companies that prepare their financial statements in accordance with relevant standards. For companies that do not prepare these statements, the Commission believes that industry participants are more familiar with the relevant accounting standards and tests, and they will be less burdensome to apply[96].

Additionally, the accounting consolidation analysis typically results in a positive outcome (consolidation) at a higher level of an affiliation relationship than the 25 percent voting interest standard of the legal control test.  This is responsive to commenters' concerns that the proposed definitions were over-inclusive.

Because there are circumstances where an entity holds a majority ownership interest and would not consolidate, the Prudential Regulators have reserved the right to include any other entity as an affiliate or subsidiary based on a conclusion that either company provides significant support to, or is materially subject to the risks or losses of, the other company.  This provision is meant to leave discretion to the Prudential

[96] The Commission is deleting the definition of the term "subsidiary."  This term is no longer used in this set of rules.

Regulators in order to avoid evasion. The Commission has determined not to include this provision at this time.

The Commission believes that the modifications to the definition of affiliate will address many of the concerns raised by commenters, including with respect to investment and pension funds. Investment funds generally are not consolidated with the asset manager other than during the seeding period or other periods in which the manager holds an outsized portion of the fund's interests although this may depend on the facts and circumstances. The Commission believes that during these periods, when an entity may own up to 100 percent of the ownership interest of an investment fund, the investment fund should be treated as an affiliate.

This approach to investment funds is similar to that in the 2013 international framework. The Commission acknowledges that some accounting standards, such as the GAAP and IFRS variable interest standards, sometimes require consolidation between a sponsor or manager and a special purpose entity created for asset management, securitization, or similar purposes, under circumstances in which the manager does not hold interests comparable to a majority equity or voting control share. On balance, the Commission believes it is appropriate to treat these consolidated entities as affiliates of their sponsors or managers. They are structured with legal separation to address the concerns of passive investors, but the manager retains such levels of influence and exposure as to indicate its status is beyond that of another minority or passive investor.

In the case of pension funds that are associated with a non-financial end user, the Commission believes that consolidation of the pension fund with its parent would be the exception to the rule under applicable accounting standards. Even if consolidation is applicable for some pension funds, the parent would, as a general matter, be exempt from the rule under TRIPRA and would not be included in the threshold amount calculations.

(vi). Treasury affiliates acting as principal

The Commission has issued no-action letters providing relief with respect to certain Treasury affiliates acting as principal from the clearing requirement provided that certain conditions are met.[97] Some commenters urged the Commission to provide similar treatment here.[98] The Commission has determined that similar treatment is appropriate. The Commission has included in the definition of financial end user a provision stating that the term shall not include an eligible treasury affiliate that the Commission has exempted by rule. The Commission will act to implement this approach by rule or staff no-action letter in a separate procedure.

The Prudential Regulators final rules do not include this provision. The Prudential Regulators have stated, however, that if the CFTC acted to exclude these entities by rule, the entities would be excluded from the Prudential Regulators' rule.[99]

(c). Non-Financial End Users

(i). Proposal

Non-financial end users under the proposal included any entity that was not an SD, an MSP, or a financial end user. The proposal did not require CSEs to exchange margin with non-financial end users. The Commission believes that such entities, which

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[97] See CFTC No-Action Letter No. 13-22 (June 4, 2013); CFTC No-Action Letter No. 14-144 (Nov. 26, 2014).
[98] See W&C (initial and variation margin should not apply to an eligible treasury affiliate as defined in Commission No-Action Letter No. 13-22).
[99] 80 FR 74840 at 74856.

generally are using swaps to hedge commercial risk, pose less risk to CSEs than financial entities.

To ensure the safety and soundness of CSEs, the proposal required a CSE (i) to enter into certain documentation with all counterparties to provide clarity about the parties' respective rights and obligations and (ii) to calculate hypothetical initial and variation margin amounts each day for positions held by non-financial entities that have material swaps exposure to the covered counterparty.[100] That is, the CSE would be required to calculate what the margin amounts would be if the counterparty were another SD or MSP and compare them to any actual margin requirements for the positions.[101] These calculations would serve as risk management tools to assist the CSE in measuring its exposure and to assist the Commission in conducting oversight of the CSE.

(ii). Comments

Many commenters supported the Commission's decision not to impose margin requirements on non-financial end users.[102] One commenter raised concerns about certain uncleared matched commodity swaps that economically offset each other and that are used to hedge municipal prepayment transactions for the supply of long-term natural gas or electricity (municipal prepayment transactions as described earlier).[103] However,

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[100] Proposed Regulations 23.154(a)(6) and 23.155(a)(3).

[101] This is consistent with the requirement set forth in section 4s(h)(3)(B)(iii)(II) of the CEA that SDs and MSPs must disclose to counterparties who are not SDs or MSPs a daily mark for uncleared swaps.

[102] See ABA; ETA; CDEU (asking the Commission to make explicit in the rule text the exclusion for non-financial end users from the margin requirements); COPE.

[103] This commenter contended that each side of this matched pair of swaps could be subject to different margin treatment that could make these transactions prohibitively expensive. In particular, according to this commenter, the first or "front-end" swap in this matched pair would be between a non-financial end user (typically a government gas supply agency) and a swap entity, while the second swap or "back-end" swap generally would be between a swap entity and a prepaid gas supplier that is a swap entity or other financial entity.

two commenters expressed concerns with this decision.[104] These concerns ranged from fears that large market players (such as the type of entities that once included Enron, among others) would be able to participate in the markets on an unmargined basis to disappointment that the Commission did not at least include a requirement for a specific internal exposure limit for commercial counterparties.

Many commenters opposed the documentation requirement in the proposal, citing administrative burdens on the parties and noting that non-financial end users currently use other forms of documentation.[105] Other commenters asked the Commission for clarification with respect to aspects of the documentation requirement.[106]

The majority of commenters opposed the hypothetical margin calculation requirement for non-financial end users.[107] Commenters generally noted the extra burdens this requirement may place on CSEs and the non-financial end user, who must monitor their swaps exposures to determine if they exceed the material swaps exposure threshold. Only one commenter expressed support for this requirement.[108]

(iii). Discussion

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[104] See Public Citizen (opposed the exemption, citing that non-financial end users are not exempt by statute); AFR (suggesting that the Commission should separate clearing and margin exemptions while expressing concerns regarding the scope of this exemption). AFR further argued that margin should be required where the volume of swaps could present risks to the financial system or to affiliated entities deemed to be systemically important.

[105] See ISDA; Joint Associations; CDEU; Freddie; COPE; ABA; ETA; BP; Shell TRM.

[106] See Sifma (seeking assurance that (i) a CSE would not violate its obligations to maintain sufficient margin if it releases margin to a counterparty at the conclusion of a dispute resolution mechanism consistent with the U.S. implementation of Basel and the Commission is not requiring the parties to lock in dispositive valuation methods; and (ii) if a non-bank swap entity and a non-financial end user have not agreed to exchange margin, the parties will not need to modify their trading documentation to address matters specified in the proposal such as valuation methodologies and data sources); JBA (seeks clarification on the level of documentation required to "allow the counterparty and regulators to calculate a reasonable approximation of the margin requirement independently); FHLB (arguing that documentation requirement with respect to dispute resolution are inadequate).

[107] See ISDA; Sifma; Joint Associations; JBA; FSR; ETA; NGCA/NCSA; CDEU; COPE; BP; Shell TRM; CEWG.

[108] See AFR.

In response to the comments, the Commission has removed the hypothetical margin calculation and documentation requirements concerning non-financial end users. Although the Commission continues to believe that its documentation and hypothetical margin calculation requirements would promote the financial soundness of CSEs, the Commission recognizes the additional administrative burdens that its proposed requirements could impose on CSEs and on non-financial end users. The Commission has other requirements that should address the monitoring of risk exposures for these entities.[109]

Moreover, under the interim final rule discussed below, certain transactions with certain financial counterparties are exempt from the Commission's margin requirements. Section 23.150 of the final rule implements the exemptions enacted in Title III of TRIPRA, which excludes these swaps from the statutory directive issued to the Commission by section 4s of the CEA to impose margin requirements for all uncleared swaps.

The Commission is implementing the transaction based (as opposed to counterparty based) TRIPRA exemptions in § 23.150(b) of the final rule. With respect to municipal prepayment transactions, the Commission notes that CSEs that are parties to these and other types of matched or offsetting swap transactions would need to evaluate each swap to determine whether the requirements of the final rule apply. Under the final rule, it is possible that one swap may be exempt from the requirements of the rule while an offsetting swap is subject to the final rule's requirements as these requirements are set on a risk basis as required under the statute.

[109] See e.g., § 23.600 of the CFTC's regulations.

A commenter also contended that the rule would cause counterparties to matched commodity swaps to face increased costs to the extent that the rules apply a capital charge to a CSE in connection with these matched swaps. The Commission notes that capital requirements of CSEs are outside the scope of this rulemaking and therefore is not addressing the capital implications of Municipal Prepayment Transactions at this time.

D. Nature and Timing of Margin Requirements

1. Initial Margin

(a). Proposal

Subject to thresholds discussed below, the proposal required each CSE to collect initial margin from, and to post initial margin with, each covered counterparty on or before the business day after execution[110] for every swap with that counterparty.[111] The proposal required the CSEs to continue to post and to collect initial margin until the swap is terminated or expires.[112]

Recognizing the greater risk that SDs, MSPs, and financial end users pose to the financial system, the Commission proposed to require SDs and MSPs to collect initial margin from, and to post initial margin with, one another. SDs and MSPs also would be required to collect initial margin from, and post initial margin to, financial end user counterparties that have exceeded the material swaps exposure threshold. SDs and MSPs would be required to collect variation margin from, and post variation margin to, each other and all financial end user counterparties.

[110] Commission Regulation 23.200(e) defines execution to mean, "an agreement by the counterparties (whether orally, in writing, electronically, or otherwise) to the terms of the swap transaction that legally binds the counterparties to such terms under applicable law." 17 CFR 23.200(e).
[111] Proposed § 23.152(a) and 23.153(d).
[112] Proposed § 23.152(b).

The proposal contains a provision stating that a CSE would not be deemed to have violated its obligation to collect initial or variation margin if it took certain steps to collect margin from its counterparty in the event the counterparty failed to post.[113] Specifically, if a counterparty failed to pay the required initial margin to the CSE, the CSE would be required to make the necessary efforts to attempt to collect the initial margin, including the timely initiation and continued pursuit of formal dispute resolution mechanisms,[114] or otherwise demonstrate upon request to the satisfaction of the Commission that it has made appropriate efforts to collect the required initial margin or commenced termination of the swap.

(b). Comments

Commenters generally expressed support for two-way initial and variation margin.[115] One commenter suggested that CSEs should not be required to post margin but only to collect margin.[116] Another commenter further supported allowing more time to raise the required initial margin if an increase is mandated as a result of model recalibration.[117]

All commenters that addressed the Commission's proposed timing requirement for initial margin collection opposed it.[118] The basis for these objections included the fact that the settlement and delivery periods for many types of eligible margin securities are longer than the time allowed for margin collection under the proposed rule; the potential inability of financial end users to arrange for collateral transfers under the

[113] Proposed § 23.152(c).
[114] See § 23.504(b)(4) of the CFTC.s regulations.
[115] See Barnard; ICI; MFA; Public Citizen; AFR; CME; GPC.
[116] See JBA.
[117] See CCMR.
[118] See JFMC; Joint Associations; JBA; Sifma; Sifma-AMG; ISDA; ETA; Shell TRM; BP; GPC; and NGSA/NGCA.

proposed rule's timeframes; and the difficulties encountered where the parties are in distant time zones.[119]

Other concerns included the fact that valuations are typically determined after market close and that the proposed rule did not include time for portfolio reconciliation and dispute resolution. A commenter suggested that, since financial end users would be required to exchange margin with a CSE in amounts determined by the CSE's models, the final rule should allow for a dispute resolution process acceptable to both the CSE and its counterparty. Commenters proposed a number of alternatives, including moving to a T+2 basis;[120] requiring prompt margin calls no later than a T+1 or T+2 basis with margin transfer occurring one or two days thereafter or according to the standard settlement cycle for the type of collateral; requiring margin collection and settlement weekly; or simply requiring margin collection on a prompt or reasonable basis.

One commenter asked for clarification that the Commission would not require the calculation and collection of margin more than once a day.[121]

(c). Discussion

(i) Two-Way Margin

Consistent with the proposal, the final rule requires a CSE to collect initial margin when it engages in an uncleared swap with another swap entity. Because all swap entities will be subject to a Prudential Regulator or Commission margin rule that requires them to collect initial margin on their uncleared swaps, the final rule will result in a collect-and-post system for all uncleared swaps between swap entities.

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[119] See ISDA; Sifma; JFMC; and JBA.
[120] See ISDA.
[121] See MFA.

When a CSE engages in an uncleared swap with a financial end user with material swaps exposure,[122] the final rule will require the CSE to collect *and* post initial margin with respect to the uncleared swap. Under the final rule, a CSE transacting with a financial end user with material swaps exposure must (i) calculate its initial margin collection amount using an approved internal model or the standardized look-up table, (ii) collect an amount of initial margin that is at least as large as the initial margin collection amount less any permitted initial margin threshold amount (which is discussed in more detail below), and (iii) post at least as much initial margin to the financial end user with material swaps exposure as the CSE would be required to collect if it were in the place of the financial end user with material swaps exposure.

The Commission is not adopting a "collect only" approach for financial end user counterparties recommended by a number of financial industry commenters. The posting requirement under the final rule is one way in which the Commission seeks to reduce overall risk to the financial system, by providing initial margin to non-dealer swap market counterparties that are interconnected participants in the financial markets (i.e., financial end users that have material swap exposure).[123] Commenters representing public interest groups and asset managers supported this aspect of the Commission's approach, stating that it not only would better protect financial end users from concerns about failure of a

[122] The calculation of "material swaps exposure" is addressed in more detail in the discussion of the definitions above.

[123] Some of these commenters contrasted the Commission's 2014 proposed approach with those of European and Japanese regulators. In the United States, many financial end users operate outside of the jurisdiction of the Commission to impose margin requirements. Thus, unlike the proposed Japanese and European requirements, which would cover a broader array of financial entities, a collect-only regime in the United States would be applicable only to CSEs and thus could leave a large number of financial entities with significant unmargined potential future exposures to their swap dealers.

CSE, but also would act as a discipline on CSEs by requiring them to post margin reflecting the risk of their swaps business.

The final rule permits a CSE to select from two methods (the standardized look-up table or the internal margin model) for calculating its initial margin requirements as described in more detail in the paragraphs that follow. In all cases, the initial margin amount required under the final rule is a minimum requirement; CSEs are not precluded from collecting additional initial margin (whether by contract or subsequent agreement with the counterparty) in such forms and amounts as the CSE believes is appropriate.

The provisions of the final rule requiring a CSE to collect initial margin amounts calculated under the standardized approach or an internal model apply only with respect to counterparties that are financial end users with material swaps exposure or swap entities.[124]

(ii) Timing

The final rule establishes the timing under which a CSE must comply with the initial margin requirements set out in §§ 23.154 and 155. Under § 23.152 of the final rule, a CSE, on each business day, must comply with the initial margin requirements for a period beginning on or before the business day following the day of execution of the swap and ending on the date the uncleared swap is terminated or expires. "Business day" is defined in § 23.151 to mean any day other than a Saturday, Sunday, or legal holiday.[125]

[124] The same is true with respect to the final rule's requirements for eligible collateral and custody of initial margin collected by a CSE.

[125] A "business day" under the final rule is not limited by or tied to typical business hours. A swap dealer seeking to post or collect margin may make the transfer during a "business day" but at a time which is before or after typical business hours.

In practice, each CSE typically will have a portfolio of swaps with a specific counterparty, and the CSE will collect and post initial margin for that portfolio with that counterparty on a rolling basis. The final rule requires the CSE to collect and post initial margin each business day for its portfolio of swaps with that counterparty, based on the initial margin amount calculated for that portfolio by the CSE on the previous business day.[126]

As the CSE and its counterparty enter into new swaps, adding them to the portfolio, these new swaps need to be incorporated into the CSE's calculation of initial margin amounts to be posted and collected on this daily cycle. When a CSE and its counterparty are located in the same or adjacent time zones, this is a straightforward process. However, when the CSE is located in a distant time zone from the counterparty, or the two parties observe different sets of legal holidays, this can be less straightforward.

The Commission added new provisions to the final rule to accommodate practical considerations that arise in these circumstances.[127] The final rule requires the CSE to post and collect initial margin on or before the end of the business day after the "day of execution," as defined in § 23.151 of the rule. The "day of execution" is determined with reference to the point in time at which the parties enter into the uncleared swap.

When the location of the CSE is in a different time zone than the location of the counterparty, the "day of execution" definition provides three special accommodations

[126] Of course, if the initial margin amounts have not changed, or the change to the posting or collecting amount (combined with changes in the variation margin amount, as applicable) is less than the minimum transfer amount specified in § 23.151, no posting or collection will be required.

[127] The approach is patterned on principles incorporated in the Commission's rulemaking on clearing execution, with differences the Commission believes are appropriate in consideration of the bilateral nature of uncleared swap margin and the non-standardized terms of uncleared swaps. See Clearing Requirement Determination Under Section 2(h) of the CEA, 77 FR 74,284 (Dec. 13, 2012), *available at*: http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-29211a.pdf

for the difference. These accommodations are made in recognition of the fact that each of the two parties to the swap will, as a practical necessity, observe its own "business day" in transmitting instructions to the third-party custodian.

First, if at the time the parties enter into the swap, it is a different calendar day at the location of each party, the day of execution is deemed to be the later of the two calendar days. For example, if a CSE located in New York enters into a swap at 3:30 p.m. on Monday with a counterparty located in Japan, in the Japanese counterparty's location, it is 4:30 a.m. on Tuesday, and the day of execution (for both parties) will be deemed to be Tuesday.

Second, if an uncleared swap is entered into between 4:00 p.m. and midnight in the location of a party, then such uncleared swap shall be deemed to have been entered into on the immediately succeeding day that is a business day for both parties, and both parties shall determine the day of execution with reference to that business day. For example, if a CSE located in New York enters into a swap at noon on Friday with a counterparty located in the U.K., and in the U.K. counterparty's location, it is 5:00 p.m. on Friday, then the U.K. counterparty will be deemed to enter into the swap the following Monday. Or, if a CSE located in New York enters into a swap at noon on Friday with a counterparty located in Japan, and in the Japanese counterparty's location, it is 1:00 a.m. on Saturday, then the Japanese counterparty will be deemed to enter into the swap the following Monday. In both examples, the day of execution (for both parties) will be Monday.

Third, if the day of execution determined under the foregoing rules is not a business day for both parties, the day of execution shall be deemed to be the immediately succeeding day that is a business day for both parties. For example, this addresses the outcome arising from an uncleared swap entered into by a CSE in New York at noon on Friday with a counterparty in Japan, where it would be 1:00 a.m. on Saturday. Under the first provision, the later calendar day would be deemed the day of execution, which would be Saturday. Accordingly, this third provision would operate to move the deemed day of execution to the next business day for both parties, i.e. Monday. As a further example under the same circumstances, except that the Monday was a legal holiday in New York, the day of execution would then be deemed to be Tuesday for both parties.

Section 23.152 consistently requires the CSE to begin posting and collecting initial margin reflecting that swap no later than the end of the business day following that day of execution and thereafter collect and post on a daily basis. The Commission believes the final rule should provide adequate time for the CSE to include the new swap in the regular initial margin cycle, under which the CSE calculates the initial margin posting and collection requirements each business day for a portfolio of swaps with a counterparty, and under which the independent custodian(s) for both parties must hold segregated eligible margin collateral in those amounts by the end of the next business day, pursuant to the respective instruction of the parties. The CSE is required to continue including the swap in its determination of the initial margin posting and collection requirements for that portfolio until the date the swap expires or is terminated.

The Commission has made limited adjustments to the final rule to accommodate operational concerns created by differences in time zones and legal holidays between the counterparties, but otherwise has retained the proposed approach. The Commission recognizes that the final rule requires initial margin to be posted and collected so quickly that CSE and their counterparties may be required to take precautionary steps. These could include (i) pre-positioning eligible margin collateral at the custodian, (ii) using readily-transferrable forms of eligible collateral, such as cash, or (iii) initially supplying readily-transferrable forms of eligible collateral and subsequently arranging to substitute other eligible margin collateral after the initial margin collateral has been delivered to the custodian and the minimum margin requirements have been satisfied.

The Commission also recognizes that the final rule will require portfolio reconciliation and dispute resolution to be performed after initial margin has been collected, as adjustments to the original margin call, rather than before. While the Commission recognizes the incremental regulatory burden created by the final rule's timing requirement, the Commission believes the additional delay that would be introduced by the commenters' alternatives would reduce the overall effectiveness of the margin requirements, as any further timing delay will result in an increased margin period of risk, which is not accounted for in calculating the initial margin amount.[128]

Under § 23.152 of the final rule, a CSE shall not be deemed to have violated its obligation to collect or post initial or variation margin from or to a counterparty if: (1) the counterparty has refused or otherwise failed to provide or accept the required margin to or from the CSE; and (2) the CSE has (i) made the necessary efforts to collect or to post the required margin, or has otherwise demonstrated upon request to the satisfaction of the Commission that it has made appropriate efforts to collect the required margin, or (ii)

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[128] For example, if the Commission provided T+3 as the required timing for the posting of margin, the initial margin model's margin period of risk of 10 days, would only end up being 7 days, as the initial margin amount would not be available for another 3 days after its calculation (i.e., 10 days (margin period of risk) - 3 days (T+3 posting requirement) =7 days).

commenced termination of the uncleared swap with the counterparty promptly following the applicable cure period and notification requirements.

Under the final rule, disputes that may arise between a CSE and its counterparty should be handled pursuant to the terms of the relevant contract or agreement and in the normal course of business. A CSE would not be deemed to have violated its obligation to collect or post initial or variation margin from or to a counterparty if the counterparty is acting in accordance with agreed-upon practices to settle a disputed trade.

2. Netting Arrangements

(a). Proposal

The proposal would permit netting of initial margin across swaps and variation margin across swaps, but would not permit the netting of initial and variation margin.[129] Any netting would have to be done pursuant to an eligible master netting agreement ("ENMA").[130] The agreement would create a single legal obligation for all individual transactions covered by the agreement upon an event of default. It would specify the rights and obligations of the parties under various circumstances.[131]

The proposed rule provided that if uncleared swaps entered into prior to the applicable compliance date were included in the EMNA, those swaps would be subject to the margin requirements.[132] Under the proposal, a CSE would need to establish a new EMNA to cover swaps entered into after the compliance date in order to exclude pre-compliance date swaps.

(b). Comments

[129] Proposed §§ 23.152(c) and 23.153(c).
[130] Proposed § 23.151, definition of "eligible master netting agreement."
[131] Id.
[132] The netting provisions in the proposal were in § 23.153(c).

A number of commenters argued that, in order to allow close-out netting and contain costs, the final rule should not require new master agreements to separate pre- and post-compliance date swaps, and that parties should be permitted to use credit support annexes that are part of the EMNA instead of new master agreements to distinguish pre-and post-compliance date swaps.[133] One party also asked the Commission for confirmation that the requirement to separately margin pre- and post-effective date swaps applies only to initial and not variation margin.[134] Another party argued that ISDA should publish and standardize a credit support annex that would conform to the requirements of the margin regulations and parties should be allowed to use such credit support annex alongside other existing credit support annexes among the parties.[135]

(c). Discussion

The final rule permits a CSE to calculate initial margin (using an initial margin model) or variation margin on an aggregate net basis across uncleared swap transactions that are executed under an EMNA.[136] Although the proposal provided that the margin requirements would not apply to uncleared swaps entered into before the rule's compliance dates, as a general rule, the proposal provided that if an EMNA covered uncleared swaps that were entered into before the applicable compliance date, those

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[133] See TIAA-CREF; CPFM; ICI; Sifma; ISDA; Sifma-AMG; ABA; JBA; CS; AIMA; MFA; FSR; Freddie; ACLI; and FHLB. One commenter also requested clarification that the use of an EMNA does not prevent use of a master-master netting agreement. The final rule requires that any uncleared swaps that are netted for purposes of calculating the margin requirements under the final rule are subject to an EMNA that meets the definition in § 23.151 of the final rule regardless of whether or not there is a master-master agreement.

[134] See ICI.

[135] See Freddie.

[136] Initial margin and variation margin amounts may not be netted against each other under the final rule. In addition, initial margin netting is only for the purposes of calculating the collection amount or post amount under an approved initial margin model, which may not be netted against each other.

uncleared swaps would be subject to the requirements of the rule and must be included in the aggregate netting portfolio for purposes of calculating the required margin.

As discussed by several commenters, the Commission recognizes that CSEs and their counterparties may wish to separate netting portfolios under a single EMNA. Accordingly, the final rule provides that an EMNA may identify one or more separate netting portfolios that independently meet the requirement for close-out netting[137] and to which, under the terms of the EMNA, the collection and posting of margin applies on an aggregate net basis separate from and exclusive of any other uncleared swaps covered by the agreement. (These separate netting portfolios are commonly covered by separate credit support annexes to the EMNA.)

This rule facilitates the ability of the parties to document two separate netting sets, one for uncleared swaps that are subject to the final rule and one for swaps that are not subject to the margin requirements. A netting portfolio that contains only uncleared swaps entered into before the applicable compliance date is not subject to the requirements of the final rule. The rule does not prohibit the parties from including one or more pre-compliance-date swaps in the netting portfolio of uncleared swaps subject to the margin rule, but they will thereby become subject to the final rule's margin requirement, as part of the netting portfolio. Similarly, any netting portfolio that contains any uncleared swap entered into after the applicable compliance date will subject the entire netting portfolio to the requirements of the final rule.

The netting provisions of the final rule also address the implications of status changes for counterparties. As discussed above, the final rule imposes a requirement to

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[137] See § 23.151 (paragraph 1 of the EMNA definition).

exchange initial margin only with respect to financial end users whose swap portfolios exceed the material swap exposure threshold. This means that a CSE may accumulate a portfolio of swaps with a financial end user below the threshold, subject to a variation margin requirement, and later if the financial end user crosses the threshold, only new swaps entered into after the change in the financial end user's status will be subject to both initial and variation margin requirements. To address this possibility, the final rule extends the treatment of separate netting portfolios under a single ENMA beyond pre-compliance-date swaps to include separate netting portfolios for swaps entered into before and after a financial end user's change into a higher risk status.[138]

The netting provisions in the final rule are modified from the proposal in order to provide clarifications to address implementation concerns raised by commenters. The proposed rule provided that if uncleared swaps entered into prior to the applicable compliance date were included in the EMNA, those swaps would be subject to the margin requirements.[139] Under the proposal, a CSE would need to establish a new EMNA to cover swaps entered into after the compliance date in order to exclude pre-compliance date swaps.

The final rule addresses the commenters' concerns regarding close-out netting and preserves close-out netting by allowing an EMNA to identify one or more separate netting portfolios to which the requirements of the final rule apply on an aggregate net basis. Thus, under the final rule, pre-compliance date swaps in the same EMNA as post-

[138] As discussed earlier, the change in status might also occur as a counterparty moves in or out of financial end user status entirely. The final rule extends the separate netting portfolio treatment to all status changes equally.

[139] The netting provisions in the proposal were in § 23.153.

compliance date swaps would be subject to the requirements of the final rule unless they are treated under the EMNA as separately identified netting portfolio.

The Commission believes it would be inconsistent with the purposes and objectives of the rule to permit a CSE to net a counterparty's uncleared swap obligations to the CSE in determining margin collection amounts, unless the CSE can conclude on a well-founded basis that the netting provisions of the agreement can be enforced against the counterparty (as required in accordance with the final rule's definition of the EMNA).

The Commission will address commenters' concerns regarding the lack of availability of netting in foreign jurisdictions in its application of the margin rule on cross-border transaction final rule.

The Commission does not believe that it would be appropriate for margin requirements for uncleared swaps to be offset by netting other products or exposures across markets against other products that may present different concerns about safety and soundness or financial stability, or that are not subject to similar associated margin requirements. Such treatment appears inconsistent with the purposes of the Dodd-Frank Act.

E. Calculation of Initial Margin

1. Overview

(a). Proposal

Under the proposed rules, a CSE could calculate initial margin using either a model-based method or a standardized table-based method.[140] The required amount of initial margin would be the amount computed pursuant to either an internal model or the

[140] Proposed § 23.154.

table minus an initial margin threshold amount of $65 million.[141] In the proposal, the initial margin threshold was calculated on a consolidated basis (i.e. including all of the entity's affiliates). This amount could not be less than zero.[142] The initial margin specified under the proposal would be a minimum requirement, and the parties would have been free to require more initial margin. To ease the transaction costs associated with the exchange of margin, the Commission also proposed a minimum transfer amount of $650,000.[143]

(b). Comments

A few commenters urged that the threshold should be set for individual legal entities within a group instead of at the group level,[144] while at least one commenter expressed support for applying the threshold to the larger consolidated group.[145] One commenter argued that firms should be required to disclose their aggregate uncollateralized exposures from use of the initial margin threshold as well as allocation of the threshold across counterparties, including affiliated counterparties.[146] The same commenter also argued that the full amount of gross initial margin should be exchanged, and asked for increased disclosure requirements regarding uncollateralized exposures (e.g., exposures that fall below the initial margin threshold).

Commenters also suggested that the minimum transfer amount should apply separately to initial and variation margin.[147] A commenter also urged the Commission to

[141] Proposed § 23.151, definition of "initial margin threshold amount."
[142] Proposed § 23.154(a)(4).
[143] Proposed § 23.151.
[144] CEWG; BP; Shell TRM; ISDA; Sifma AMG.
[145] Public Citizen.
[146] CME.
[147] See ISDA; JBA; Sifma.

revisit the amounts periodically to ensure international consistency.[148] Another commenter suggested that entities for which the U.S. Dollar is not the common or transacting currency or whose payment obligations are in another currency should be allowed to use an average exchange rate between the U.S. Dollar and the foreign currency for calculating thresholds.[149] One commenter also suggested that the Commission allow the counterparties to set a minimum transfer amount below $ 650,000.[150] Another commenter requested confirmation that the rule allows a minimum transfer amount but does not require it.

Commenters also asked for separate treatment of various arrangements under which the assets of a single investment fund or pension plan are treated as separate portfolios or accounts, each assigned some portion of the fund's or plan's total assets for purposes of managing them pursuant to different investment strategies or by different investment managers as agent for the fund or plan.[151] Commenters said these "separate accounts" are generally managed under documentation that caps the asset manager's ability to incur liabilities on behalf of the fund or plan at the amount of the assets allocated to the account.

(c). Discussion

As an initial matter, the final rules allow CSEs to choose between model-based and table-based initial margin calculations. The Commission expects that some CSEs may choose to adopt a mix of internal models and standardized approaches to calculating

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[148] See Sifma.
[149] See ICI.
[150] See Shell TRM.
[151] One industry group commenter also cited as an example a securitization vehicle that creates separate issuances of asset-backed securities through use of a series trust.

initial margin requirements. For example, it may be the case that a CSE engages in some swap transactions on an infrequent basis to meet client demands but the level of activity does not warrant all of the costs associated with building, maintaining, and overseeing a quantitative initial margin model. Further, some CSE clients may value the transparency and simplicity of the standardized approach. In such cases, the Commission expects that it would be acceptable to use the standardized approach to margin such swaps.

Under certain circumstances it may be appropriate to employ both a model based and standardized approach to calculating initial margins. At the same time, the Commission is aware that differences between the standardized approach and internal model based margins across different types of swaps could be used to "cherry pick" the method that results in the lowest margin requirement. Rather, the choice to use one method over the other should be based on fundamental considerations apart from which method produces the most favorable margin results. Similarly, the Commission does not anticipate there should be a need for CSEs to switch between the standardized or model-based margin methods for a particular counterparty, absent a significant change in the nature of the entity's swap activities. The Commission expects CSEs to provide a rationale for changing methodologies if requested. The Commission will monitor for evasion of the swap margin requirements through selective application of the model and standardized approach as a means of lowering the margin requirements.

The final rule does not require a CSE to collect or to post initial margin collateral to the extent that the aggregate un-margined exposure either to or from its counterparty remains below $50 million.[152] In this regard, the final rule is generally consistent with

[152] § 23.151, definition of "initial margin threshold amount."

the 2013 international framework and the 2014 proposal.  The initial margin threshold amount of $50 million has been adjusted relative to the $65 million threshold in the proposed rule in the manner described below.

The Commission believes that allowing CSEs to apply initial margin thresholds of up to $50 million is consistent with the rule's risk-based approach, as it will provide relief to counterparties, while ensuring that initial margin is collected from those counterparties with exposure over the threshold, which could pose greater systemic risk to the financial system.  The initial margin threshold also should serve to reduce the aggregate amount of initial margin collateral required by the final rule.

Under the final rule, the initial margin threshold applies on a consolidated entity level.  It will be calculated across all non-exempted[153] uncleared swaps between a CSE and its affiliates and the counterparty and the counterparty's affiliates.[154]  The requirement to apply the threshold on a fully consolidated basis applies to both the counterparty to which the threshold is being extended and the counterparty that is extending the threshold.  Applying this threshold on a consolidated entity level precludes the possibility that CSEs and their counterparties could create legal entities and netting sets that have no economic basis and are constructed solely for the purpose of applying additional thresholds to evade margin requirements.

Although some commenters suggested the Commission should not implement the threshold across the CSE and counterparties on a consolidated basis, and instead rely on

[153] To the extent that an uncleared swap transaction is exempt from the margin requirements pursuant to § 23.150(b), consistent with TRIPRA, the interim final rule excludes the exempted swap transaction from the calculation of the initial margin threshold amount.
[154] The threshold may be allocated among entities within the consolidated group, at the agreement of the CSE and the counterparties, but the total must remain below $50 million on a combined basis.  For an example illustrating allocations, see the 2014 proposal.

general anti-evasion authority to address efforts to exploit the threshold, the Commission has not done so. The revisions to the affiliate and subsidiary definitions in the final rule, described above, simplify implementation of the consolidated approach and should help address some of the concerns raised by commenters in this respect.

The Commission notes that the threshold represents a minimum requirement and should not be viewed as preventing parties from contracting with each other to require the collection of initial margin at a lower threshold, using the same method as set forth in the final rule. For such transactions, the Commission expects CSEs to make their own internal credit assessments when making determinations as to the credit and other risks presented by their specific counterparties. Therefore, a CSE dealing with a counterparty it judges to be of high credit quality may determine that a counterparty-specific threshold of up to $50 million is appropriate.

In response to commenters, and to clarify the Commission's intent, the Commission notes that the $50 million threshold is measured as the amount of initial margin for the relevant portfolio of uncleared swaps pursuant to either the internal model or standardized initial margin table used by the CSE.[155] The Commission has not incorporated suggestions by a commenter that the Commission permit the threshold to be calculated in foreign currencies. Conversion to USD can be readily accomplished and provides a measure of relative consistency in application from counterparty to counterparty within and across CSEs.

[155] Although one commenter urged the Commission to require CSEs to make granular disclosures about the use of the $65 million threshold to their investors, credit providers, and the central counterparties of which the CSE is a member, the suggestion is beyond the scope of this margin rulemaking. The Commission notes the final rule does not prohibit a CSE from providing this information, should it wish to negotiate that arrangement with an interested party.

In addition, the Commission has not incorporated suggestions by commenters for separate treatment of various arrangements under which the assets of a single investment fund vehicle or pension plan are treated as separate portfolios or accounts, each assigned some portion of the fund's or plan's total assets for purposes of managing them pursuant to different investment strategies or by different investment managers as agent for the fund or plan.[156] Commenters said these "separate accounts" are generally managed under documentation that caps the asset manager's ability to incur liabilities on behalf of the fund or plan at the amount of the assets allocated to the account.

While the Commission recognizes these types of asset management approaches are well-established industry practice, and that separate managers acting for the same fund or plan do not currently take steps to inform the fund or plan of their uncleared swap exposures on behalf of their principal on a frequent basis, the Commission is not persuaded that it would be appropriate to extend each separate account its own initial margin threshold. Based on the comments, it appears the liability cap on each account manager often will be reflected in the fund's or plan's contract with the manager. If one manager breaches its limit, there could be cross-default implications for other managed accounts, and in periods of market stress, the cumulative effect of multiple managers' uncleared swaps could, in turn, strain the fund or plan's resources. Because all the swaps are transacted on behalf of a single legal principal, the Commission does not believe that the subdivision of these separately managed accounts is sufficient to merit the extension

[156] One industry group commenter also cited as an example a securitization vehicle that creates separate issuances of asset-backed securities through use of a series trust.

of separate thresholds.[157] Nevertheless, the Commission expects that in most cases, two separate investment funds of a single asset manager would not be consolidated under the relevant accounting standards and thus would not be affiliates under this rule.

The final rule provides for a minimum transfer amount for the collection and posting of margin by CSEs. The final rule does not require a CSE to collect or post 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 rule, but has not yet been exchanged with the counterparty, is greater than $500,000.[158] This minimum transfer amount is consistent with the 2013 international framework and has been adjusted relative to the amount that appeared in the proposal in the manner described below.

The final rule has been modified from the proposal to make clear that the minimum transfer amount applies to the combined amount of initial and variation margin. The Commission believes that the proposal's minimum transfer amount of $500,000 is appropriately sized to generally alleviate the operational burdens associated with making de minimis margin transfers and that the amount applies to both initial and variation margin transfers on a combined basis. The Commission also confirms that the minimum

[157] Some commenters expressing this concern made the same point with respect to application of the material swaps exposure threshold, which is also calculated on a legal entity basis. The Commission has the same reservations about subdividing the material swaps exposure test at the managed account level, and these reservations are even somewhat compounded given that the Commission has revised the threshold to $8 billion in reflection of the financial end user's overall market exposure, instead of a CSE-specific exposure.

[158] See § 23.151 of the final rule. The minimum transfer amount only affects the timing of margin collection; it does not change the amount of margin that must be collected once the $500,000 threshold is crossed. For example, if the margin amount due from (or to) the counterparty were to increase from $500,000 to $800,000, the CSE would be required to collect the entire $800,000 (subject to application of any applicable initial margin threshold amount).

transfer amount is allowed but not required under the final rule, and parties are free to collect and post margin below that amount.

2. Models

As in the proposed rule, the final rule adopts an approach whereby CSEs may calculate initial margin requirements using an approved initial margin model. As in the case of the proposal, the final rule also requires that the initial margin amount be set equal to a model's calculation of the potential future exposure of the uncleared swap consistent with a one-tailed 99 percent confidence level over a 10-day close-out period. More specifically, under the final rule, initial margin models must capture all of the material risks that affect the uncleared swap including material non-linear price characteristics of the swap.[159]

For example, the initial margin calculation for a swap that is an option on an underlying asset, such as an option on a credit default swap contract, would be required to capture material non-linearities arising from changes in the price of the underlying asset or changes in its volatility. Moreover, the margin calculations for derivatives in distinct product-based asset classes, such as equity and credit, must be performed separately without regard to derivatives contracts in other asset classes. Each derivative

[159] See § 23.154(b)(2) of the final rule. An exception to this requirement has been made in the specific case of cross-currency swaps. In a cross-currency swap, 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 that is agreed upon at the inception of the swap.
Under the final rule, an initial margin model need not recognize any risks or risk factors associated with the foreign exchange transactions associated with the fixed exchange of principal embedded in a cross-currency swap as defined in § 23.151 of the final rule. The initial margin model must recognize all risks and risk factors associated with all other payments and cash flows that occur during the life of the cross-currency swap. In the context of the standardized margin approach, described further below, the gross initial margin rates have been set equal to those for interest rate swaps. This treatment recognizes that cross-currency swaps are subject to risks arising from fluctuations in interest rates but does not recognize any risks associated with the fixed exchange of principal since principal is typically not exchanged on interest rate swaps.

contract must be assigned to a single asset class in accordance with the classifications presented in the final rule (i.e., foreign exchange or interest rate, commodity, credit, and equity). The presence of any common risks or risk factors across asset classes cannot be recognized for initial margin purposes.

The Commission's belief is that these modeling standards should ensure a strong initial margin regime for uncleared swaps that sufficiently limits systemic risk and reduces potential counterparty exposures.

(a). Commission Approval

The proposal required CSEs to obtain the written approval of the Commission before using a model to calculate initial margin.[160] The CSE would have to demonstrate that the model satisfied all of the requirements of this section on an ongoing basis.[161] In addition, a CSE would have to notify the Commission in writing before extending the use of a model that has been approved for one or more types of products to any additional product types, making any change to any initial margin model that has been approved that would result in a material change in the CSE's assessment of initial margin requirements, or making any material change to assumptions used in an approved model.[162] The Commission could rescind its approval of a model if the Commission determined that the model no longer complied with this section.[163]

(i). Comments

[160] Proposed § 23.154(b)(1). See BCBS/IOSCO Report at 12: "any quantitative model that is used for initial margin purposes must be approved by the relevant supervisory authority."
[161] Id.
[162] Proposed § 23.154(b)(1).
[163] Id.

While one commenter disapproved of the use of proprietary initial margin models,[164] several commenters supported the use of either a proprietary[165] or a standardized (developed by the industry) initial margin model.[166] One commenter urged the Commission to recognize a model that has been approved by other regulators, including foreign authorities in jurisdictions with margin requirements consistent with the 2013 international standards.[167] Another commenter suggested that the Commission provide more information regarding the process for model approval.[168]

(ii). Discussion

Under the final regulations, all initial margin models must be approved before being used for margin calculation purposes. In the event that a model is not approved, initial margin calculations would have to be performed according to the standardized initial margin approach that is detailed in Regulation 23.154(c) and discussed below.

Given the number of SDs and the likely complexity of the models, the Commission is concerned that, with its limited resources, it might not be able to review models as thoroughly and expeditiously as it would like. Accordingly, the Commission has determined to amend the final rules to provide that a CSE may use a model approved by a registered futures association ("RFA") or the Commission. Currently, the National Futures Association ("NFA") is the only RFA.

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[164] See AFR (supporting instead the adoption of a unified modeling capacity within the regulatory community).
[165] See Barnard; SIFMA; GPC (cautioning that initial margin models must be consistent with commonly accepted market practice and should be open for review by market participants).
[166] See CPFM; Sifma; MetLife; Freddie; AFR.
[167] See IFM.
[168] See JBA (asking the Commission to provide information regarding the data and documents necessary to the process, and also the timeline for the submissions); see also Shell TRM (urging the Commission to adopt a process for provisional approval of models).

As an RFA, NFA is required to establish minimum capital and other financial requirements applicable to its members that are at least as stringent as the capital and financial requirements imposed by the Commission. This requirement to establish financial requirements extends to SD and MSP margin requirements for uncleared swap transactions.

The Commission anticipates that NFA margin rules will recognize the use of models, and that the minimum requirements for such models, including the quantitative and qualitative requirements of the models, are the same as, or more stringent than, the requirements set forth in final § 23.154. Accordingly, final § 23.154 provides that an SD or MSP may use models to compute initial margin requirements if such models have been approved by NFA.

Given that CSEs may engage in highly specialized and complex swap dealing activity, it is expected that specific initial margin models may vary across CSEs. Accordingly, the specific analyses that will be undertaken in the context of any single model review may have to be tailored to the specific swap dealing activity of the CSE. Initial margin models will also undergo periodic reviews to ensure that they remain compliant with the requirements of the rule and are consistent with existing best practices over time.

Given the complexity and diverse nature of uncleared swaps, it is expected that CSEs may choose to make use of vendor-supplied products and services in developing their own initial margin models. The final rule does not place any limitations or restrictions on the use of vendor-supplied model components such as specific data feeds, computing environments, or calculation engines beyond those requirements that must be satisfied by any initial margin model. In particular, the Commission will conduct a holistic review of the entire initial margin model and assess whether the entire model and related inputs and processes meet the requirements of the final rule.[169]

To the extent that a CSE uses vendor-supplied inputs in conjunction with its own internal inputs and processes, the model approval decision will apply to the specific initial margin model used by a CSE and not to a generally available vendor-supplied model. To the extent that one or more vendors provide models or model-related inputs (e.g., calculation engines) that, in conjunction with the CSEs' own internal methods and processes, are part of an approved initial margin model, the Commission may also approve those vendor models and model-related inputs for use by other CSEs though that determination will be made on a case-by-case basis depending on the entirety of the processes that are employed in the application of the vendor-supplied inputs and models by a CSE.

In many instances, CSEs whose margin models would be subject to Commission or RFA review would be affiliates of entities whose margin models would be subject to review by one of the Prudential Regulators. In such situations, the Commission or the RFA would coordinate with the Prudential Regulators in order to avoid duplicative efforts and to provide expedited approval of Prudential Regulator approved models.[170] For example, if a Prudential Regulator had approved a model of an insured depository institution registered as an SD, Commission or RFA review of a comparable model used by its non-bank affiliate would be greatly facilitated. Similarly, the Commission or the

[169] The Commission expects that NFA will conduct a similar process for the models it reviews.

[170] Whether an initial margin model has obtained a Prudential Regulators approval will be given a significant weight in determining whether the model meets the Commission's standards.

RFA would coordinate with the SEC for CSEs that are dually registered and would coordinate with foreign regulators that had approved margin models for foreign CSEs.

The provision permitting a CSE to use a model approved by an RFA is a point of distinction between the Commission's rules and those of the Prudential Regulators. The Prudential Regulators do not have a comparable rule.

(b). Applicability to Multiple Swaps

(i). Proposal

The proposal provided that to the extent more than one uncleared swap is executed pursuant to an EMNA[171] between a CSE and a covered counterparty, the CSE would be permitted to calculate initial margin on an aggregate basis with respect to all uncleared swaps governed by such agreement.[172] However, only exposures in certain asset classes could be offset. If the agreement covered uncleared swaps entered into before the applicable compliance date, those swaps would have to be included in the calculation.[173]

The proposal defined EMNA as any written, legally enforceable netting agreement that creates a single legal obligation for all individual transactions covered by the agreement upon an event of default (including receivership, insolvency, liquidation, or similar proceeding) provided that certain conditions are met. These conditions include requirements with respect to the CSE's right to terminate the contract and to liquidate collateral and certain standards with respect to legal review of the agreement to ensure that it meets the criteria in the definition.

[171] This term is defined in proposed § 23.151.
[172] Proposed § 23.154(b)(2).
[173] Id.

(ii). Comments

A number of commenters requested that the Commission remove the "suspends or conditions payment" language.[174] These commenters argued that this provision would be inconsistent with the ISDA Master Agreement which allows a non-defaulting counterparty to suspend payment to a defaulting counterparty.[175]

A few commenters urged the Commission to align its definition with that of the Prudential Regulators,[176] while others argued that ISDA master agreements should qualify as ENMAs.[177] One commenter supported the use of netting agreements,[178] while others cautioned that entities operating in jurisdictions where netting is not enforceable may be penalized by having to put up a greater amount of collateral.[179]

Commenters generally expressed support for the recognition of foreign stays in the proposal's definition of ENMA.[180] A few commenters argued that a limited stay under State insolvency and receivership laws applicable to insurance companies also

[174] ACLI; FSR; Freddie; ISDA; MetLife; Sifma AMG; Sifma; and Vanguard.
[175] One commenter urged the Commission not to "outsource" the EMNA definition to ISDA, noting that the vast majority of existing master netting agreements are governed by the ISDA Master Agreement. The commenter argued that the ISDA Master Agreement contains provisions that may be contrary to the interests of counterparties other than ISDA's large swap entity members, such as mandatory arbitration covenants. See Better Markets. So long as an agreement meets the requirements of the EMNA definition, however, the Commission is not endorsing, requiring. or prohibiting use of a particular master netting agreement in the final rule.
[176] See Sifma; FHLB.
[177] See ETA; Joint Associations; NGSA/NGCA.
[178] See Barnard.
[179] See JFMC. See also ISDA (suggesting netting restrictions on posting variation margin (where restricted by law for example) to non-netting counterparties).
[180] AIMA; ICI; SIFMA. However, at least one commenter expressed concern that allowing for foreign jurisdiction and contractual stays could limit important bankruptcy protections for commercial end users and argued that the rule should recognize and clearly state that market participants' rights to avoid stays and other limitations of their close-out rights should be protected. CEWG.

should be recognized under this provision.[181] Some commenters also argued for permitting appropriate contractual stays.[182]

A number of commenters expressed various concerns with the provision of the EMNA that requires a CSE to conduct sufficient legal review to conclude with a well-founded basis (and maintains sufficient written documentation of that legal review) that the agreement meets the requirements with respect to the CSE's right to terminate the contract and liquidate collateral and that in the event of a legal challenge (including one resulting from default or from receivership, insolvency, liquidation, or similar proceeding), the relevant court and administrative authorities would find the agreement to be legal, valid, binding, and enforceable under the law of the relevant jurisdictions.[183] These commenters urged that requiring a legal opinion would be expensive and may not be able to be given without qualification, meaning parties can never be certain that a contract is enforceable.[184] Some of these commenters recommended removing the requirement that the ENMA be enforceable in multiple jurisdictions since it would be legally impractical.[185]

(iii). Discussion

The final rule defines an EMNA to be any written, legally enforceable netting agreement that creates a single legal obligation for all individual transactions covered by

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[181] See ACLI; MetLife.
[182] See ISDA; Sifma AMG (a party should be allowed to suspend ongoing performance where an event of default or potential event of default has occurred and is continuing); AFR (upon the default of a party, the non-defaulting party should be allowed to enter into a limited contractual stay and suspend payment obligation to the defaulting party according to the process set forth in the ISDA 2014 Resolution Stay Protocol).
[183] One commenter, for example, urged "would" should be changed to "should" as "would" is difficult to satisfy in bankruptcy courts making it difficult to state with certainty. CEWG.
[184] ACLI; GPC; ICI; JBA; Sifma AMG; see also CEWG.
[185] See GPC; Sifma AMG.

the agreement upon an event of default (including receivership, insolvency, liquidation, or similar proceeding) provided that certain conditions are met.[186] These conditions include requirements with respect to the CSE's right to terminate the contract and liquidate collateral and certain standards with respect to legal review of the agreement to ensure it meets the criteria in the definition. The legal review must be sufficient so that the CSE may conclude with a well-founded basis that, among other things, the contract would be found legal, binding, and enforceable under the law of the relevant jurisdiction and that the contract meets the other requirements of the definition.

The EMNA definition includes a requirement that the agreement not include a walkaway clause, which is defined as a provision that permits a non-defaulting counterparty to make a lower payment than it otherwise would make under the agreement, or no payment at all, to a defaulter or the estate of a defaulter, even if the defaulter or the estate of the defaulter is a net creditor under the agreement.

The proposed EMNA definition included additional language in the definition of walkaway clause that would expressly preclude an EMNA from including a clause that permits a non-defaulting counterparty to "suspend or condition payment" to a defaulter or the estate of a defaulter, even if the defaulter or the estate of the defaulter is or otherwise would be, a net creditor under the agreement. This additional language is not being included in the final rule's definition of EMNA. Therefore, the commenters' concerns regarding the impact of the additional proposed language on current provisions of the ISDA Master Agreement are moot.

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[186] This definition of ENMA aligns with the recently adopted definition of a "qualifying master netting agreement" for bank regulatory capital purposes and the Prudential Regulators' margin requirements. See Regulatory Capital Rules, Liquidity Coverage Ratio: Interim Final Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions, 79 FR 78287 (Dec. 30, 2014).

Like the proposal, the final rule's definition of EMNA contains a stay condition regarding certain insolvency regimes where rights can be stayed. In particular, the second clause of this condition has been modified to provide that any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions, other than (i) in receivership, conservatorship, or resolution by a Prudential Regulator exercising its statutory authority, or substantially similar laws in foreign jurisdictions that provide for limited stays to facilitate the orderly resolution of financial institutions, or (ii) in an agreement subject by its terms to any of the foregoing laws.[187]

The Commission did not modify the final rule's definition of EMNA to recognize stays under State insolvency and receivership laws for insurance companies. The Commission believes that other changes to the rule should help address these concerns as explained further below.

The Commission did not modify the provision relating to the legal enforceability of the EMNA definition in the final rule. The Commission believes that the legal review must be sufficient so that the CSE may conclude with a well-founded basis that, among other things, the contract would be found legal, binding, and enforceable under the law of the relevant jurisdiction and that the contract meets the other requirements of the definition. In some cases, the legal review requirement could be met by reasoned reliance on a commissioned legal opinion or an in-house counsel analysis. In other cases, for example, those involving certain new derivative transactions or derivative counterparties in jurisdictions where a CSE has little experience, the CSE would be expected to obtain an explicit, written legal opinion from external or internal legal

[187] See § 23.151.

counsel addressing the particular situation. The rules set an outcome-based standard for a review that is sufficient so that an institution may conclude with a well-founded basis that, among other things, the contract would be found legal, binding, and enforceable under the law of the relevant jurisdiction and that the contract meets the other requirements of the definition.

The Commission recognizes that there may be certain jurisdictions where a netting arrangement may not be enforceable; the Commission will address this issue in its final rule on the application of margin rule to cross-border transactions.

(c). Elements of a Model

The final rule specifies a number of conditions that a model would have to meet to receive Commission approval.[188] These conditions relate to the technical aspects of the model as well as broader oversight and governance standards. They include, among others, the following.

(i) Ten-day Close-Out Period

Under the proposal, the model must calculate potential future exposure using a one-tailed 99 percent confidence interval for an increase in the value of the uncleared swap or netting set of uncleared swaps 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 ten business days or the maturity of the swap.

The Commission received a number of comments concerning the length of the assumed close-out period used in the initial margin calculations. Commenters suggested

[188] Proposed § 23.154(b)(3).

that ten days was too long and suggested that a close-out period of three to five days was adequate to ensure sufficient time to close out or hedge a defaulting counterparty's swap contract.[189] Another commenter suggested that a ten day close out period was too short and that the resulting initial margins would not always be larger and more conservative than initial margins charged on cleared swaps.[190] The same commenter also argued that the Commission should require an ex-post 99% initial margin coverage and not simply a 99% confidence level sampling to better reflect the liquidity and risk profile of the uncleared markets and to retain incentives to promote central clearing. One commenter argued that mandating a 10 day close out period for all swaps is not sufficiently risk-sensitive as the approach fails to take into account the liquidity of any particular swap.[191] Another commenter argued for allowing market participants to determine appropriate market-based liquidation periods.[192] Two commenters supported the 10-day holding period.[193]

Since uncleared swaps are expected to be less liquid than cleared swaps, the final rule specifies a minimum close-out period for the initial margin model of 10 business days, compared with a typical requirement of 3 to 5 business days used by central counterparties (CCPs).[194] Accordingly, to the extent that uncleared swaps are expected to be less liquid than cleared swaps and to the extent that related capital rules which also mitigate counterparty credit risk similarly require a 10-day close-out period assumption,

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[189] Pension Coalition. See also CCMR (10 day horizon is not risk-adjusted and the horizon should be set according to the type of swap); ISDA (liquidity horizon should be consistent with requirements in other jurisdictions); Sifma AMG (the horizon should be closer to 5 days).
[190] CME.
[191] See CCMR.
[192] See NERA.
[193] See Public Citizen; AFR.
[194] See § 23.154(b)(2)(i) of the final rule.

the Commission's view is that a 10-day close-out period assumption for margin purposes is appropriate.[195]

At the same time, the Commission is aware that it may not be the case that the regulatory minimum required initial margin on an uncleared swap will always be larger than the initial margin required on any related cleared swap as margining practices vary among DCOs. In some cases, they may exceed minimum required margin levels due to the specific risk of the swap in question and the margining practices of the DCO. Moreover, given the complexity and diversity of the uncleared swap market, the Commission believes that it is not possible and unnecessary to prescribe a specific and different close-out horizon for each type of uncleared swap that may exist in the marketplace. The Commission does believe that it is appropriate for a CSE to use a close-out period longer than ten-days in those circumstances in which the specific risk of the swap indicates that doing so is prudent. In terms of specifying a regulatory minimum requirement, however, the Commission believes that a ten-day close-out period is sufficiently long to generally guard against the heightened risk of less liquid, uncleared swaps.

Under the final rule, the initial margin model calculation must be performed directly over a 10-day period. In the context of bank regulatory capital rules, a long horizon calculation (such as 10 days), under certain circumstances, may be indirectly computed by making a calculation over a shorter horizon (such as 1 day) and then scaling the result of the shorter horizon calculation to be consistent with the longer horizon. The rule does not provide this option to CSEs using an approved initial margin model. The

[195] In cases where a swap has a remaining maturity of less than 10 days, the remaining maturity of the swap, rather than 10 days, may be used as the close-out period in the margin model calculation.

Commission’s view is that the rationale for allowing such indirect calculations that rely on scaling shorter horizon calculations has largely been based on computational and cost considerations that were material in the past but are much less so in light of advances in computational speeds and reduced computing costs. Moreover, the Commission believes that the more accurate approach would be to use the 10 day period rather than the scaling approach. Therefore, as a result of the less burdensome calculations, the Commission is retaining this requirement.

(ii) Portfolio Offsets

Under the proposal, an initial margin model may reflect offsetting exposures, diversification, and other hedging benefits for uncleared swaps that are governed by the same EMNA by incorporating empirical correlations within the broad risk categories, provided the CSE validates and demonstrates the reasonableness of its process for modeling and measuring hedging benefits. Under the proposal, the categories were agriculture, credit, energy, equity, foreign exchange/interest rate, metals, and other. Empirical correlations under an eligible master netting agreement could be recognized by the model within each broad risk category, but not across broad risk categories. In the proposal, the sum of the initial margins calculated for each broad risk category would be used to determine the aggregate initial margin due from the counterparty.

The Commission received comments on a range of issues that broadly relate to the recognition of portfolio risk offsets.

One commenter requested that the rule specify only a single commodity asset class rather than the four separate asset classes that were set forth in the proposal (agricultural commodities, energy commodities, metal commodities and other commodities).[196] Another commenter suggested that the margin requirements should be more reflective of risk offsets that exist between disparate asset classes such as equity and commodities.[197]

Many commenters generally argued for allowing a broader set of offsets. Some commenters suggested that for the purposes of calculating model-based initial margin amounts portfolio offsets should be recognized between uncleared swaps, cleared swaps, and other products such as positions in securities or futures.[198] Some commenters promoted a "risk factor based" approach and suggested that initial margin models should allow for offsets across risk factors even if these risk factors are present in uncleared swaps across multiple asset classes such as equity and credit.[199]

For example, the commenters stated that both an equity swap and a credit swap may be exposed to some amount of interest rate risk. The commenters suggested that the interest rate risk inherent in the equity and credit swaps should be recognized on a portfolio basis so that any offsetting interest rate exposure across the two swaps could be recognized in the initial margin model. This approach would effectively require that all uncleared swaps be described in terms of a number of "risk factors" and the initial margin

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[196] See Sifma (Bentsen) (suggesting that there are significant and relatively stable correlations across related commodity categories that should not be ignored for hedging and margining purposes; commodity index swaps are a significant source of uncleared commodity swap activity and these swaps are a significant source of uncleared commodity swap activity and comprise exposures to each of the four commodity sub-asset classes that were identified; implementing the proposal's four separate sub-asset classes would not be appropriately risk sensitive and would be difficult and burdensome to implement for a significant class of commodity swaps); see also ISDA (all commodities should be one asset class as would be consistent with the 2013 international framework).

[197] Sifma AMG

[198] CCMR; GPC; CEWG; Sifma; MFA; Sifma AMG (offsets should be allowed for risk across all instruments and asset classes subject to the same master netting agreement so long as there is sound theoretical basis and significant empirical support); IECA and BP (netting should be allowed across swaps and physical commodity forward transactions entered pursuant to an ISDA master agreement with physical annexes).

[199] See ISDA (some assets may be classified as swaps in one jurisdiction but as some other type of financial instrument in another jurisdiction); Sifma; JBA.

model would consider the exposure to each risk factor separately. The initial margin amount required on a portfolio of uncleared swaps would then be computed as the sum of the amounts required for each risk factor.

This "risk factor" based approach described above is different from the Commission's proposal. Under the proposal, initial margin on a portfolio of uncleared swaps was calculated on a product-level basis. In terms of the above example, initial margin would have been calculated separately for the equity swap and calculated separately for the credit swap. In the case of both the equity and credit swap, interest rate risk in the swap would have been modeled and measured without regard to the interest rate exposure of the other swap. The total initial margin requirement would have been the sum of the initial margin requirement for the equity swap and the credit swap. Accordingly, no offset would have been recognized between any potentially offsetting interest rate exposure in the equity and credit swap.

The final rule permits a CSE to use an internal initial margin model that reflects offsetting exposures, diversification, and other hedging benefits within four broad risk categories: credit, equity, foreign exchange and interest rates (considered together as a single asset class), and commodities when calculating initial margin for a particular counterparty if the uncleared swaps are executed under the same EMNA.[200]

The rule no longer divides commodities into smaller asset classes. The Commission has decided to group all uncleared commodity swaps into a single asset class for initial margin calculation purposes. The Commission believes that there is enough commonality across different commodity categories to warrant recognition of

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[200] See final rule § 23.154(b)(2)(v).

conceptually sound and empirically justified risk offsets. Moreover, the Commission notes that both the proposal and the final rule take a relatively broad view of the other asset classes: equity, credit, interest rates and foreign exchange. In prescribing the granularity of the asset classes there is a clear trade-off between simplicity and certainty around the stability of hedging relationships in narrowly defined asset classes and the greater flexibility and risk sensitivity that is provided by broader asset class distinctions. Therefore, the Commission has decided to adopt a commodity asset class definition that is consistent with the other three asset classes and is appropriate in light of current market practices and conventions.

The final rule does not permit an initial margin model to reflect offsetting exposures, diversification, or other hedging benefits across broad risk categories.[201] Hence, the margin calculations for derivatives in distinct product-based asset classes, such as equity and credit, must be performed separately without regard to derivatives contracts in other asset classes. Each derivative contract must be assigned to a single asset class in accordance with the asset class classification presented in the standardized minimum gross initial margin requirements for uncleared swaps. The presence of any common risks or risk factors across asset classes cannot be recognized for initial margin purposes.

As a specific example, if a CSE entered into two uncleared credit swaps and two uncleared commodity swaps with a single counterparty under an EMNA, the CSE could use an approved initial margin model to perform two separate initial margin calculations: the initial margin collection amount calculation for the uncleared credit swaps and the

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[201] Id.

initial margin collection amount calculation for the uncleared commodity swaps. Each calculation could recognize offsetting and diversification within the uncleared credit swaps and within the uncleared commodity swaps. The result of the two separate calculations would then be summed together to arrive at the total initial margin collection amount for the four uncleared swaps (two uncleared credit swaps and two uncleared commodity swaps).

The Commission believes that the qualitative and quantitative basis for allowing for risk offsets among uncleared swaps within a given, and relatively broad, asset class such as equities is conceptually stronger and better supported by historical data and experience than is the basis for recognizing such offsets across disparate asset classes such as foreign exchange and commodities. Uncleared swaps that trade within a given asset class, such as equities, are likely to be subject to similar market fundamentals and dynamics as the underlying instruments themselves trade in related markets and represent claims on related financial assets. In such cases, it is more likely that a stable and systematic relationship exists that can form the conceptual and empirical basis for applying risk offsets.

By contrast, uncleared swaps in disparate asset classes such as foreign exchange and commodities are generally unlikely to be influenced by similar market fundamentals and dynamics that would suggest a stable relationship upon which reasonable risk offsets could be based. Rather, to the extent that empirical data and analysis suggest some degree of risk offset exists between swaps in disparate asset classes, this relationship may change unexpectedly over time in ways that could demonstrably weaken the assumed risk offset. Accordingly, the Commission has decided to allow for risk offsets that have a sound conceptual and empirical basis across uncleared swaps within the broad asset classes as listed in the final rule but not to allow risk offsets across swaps in differing asset classes.

Moreover, the Commission notes that the final asset class described above is interest rates and foreign exchange taken as a group. Accordingly, the final rule will allow conceptually sound and empirically supported risk offsets between an interest rate swap on a foreign interest rate and a currency swap in a foreign currency.

The Commission has considered the risk factor based approach described above and has decided not to adopt that approach, but to adopt the proposed approach in the final rule for a number of reasons.

First, a product-based approach to calculating initial margin is clear and transparent. In many market segments it is quite common to report and measure swap exposures on a product-level basis.[202] As an example, the Bank for International Settlements regularly publishes data on the outstanding notional amounts of OTC derivatives on a product-level basis. In addition, existing trade repositories, such as the DTCC global trade repositories for interest rate and credit swaps, report credit and interest rate derivatives on a product-level basis. Moreover, a risk factor based approach has the potential to be opaque and unwieldy. Modern derivative pricing models that are used by banks and other market participants may employ hundreds of risk factors that are not standardized across products or models.

While it is the case that some swaps may have hybrid features that make it challenging to assign them to one specific asset class, the Commission believes that the

[202] http://www.bis.org/statistics/dt1920a.pdf

incidence of this occurrence will be relatively uncommon and can be dealt with under the final rule. In particular, as of December 2014, the Bank for International Settlements reports that of the roughly $630 trillion in gross notional outstanding, roughly 3.6 percent of these contracts cannot be allocated to one of the following broad asset categories: foreign exchange, interest rate, equity, commodity and credit. The Commission also notes that this fraction has declined from roughly 6.6 percent in June 2012 which suggests that the challenges associated with such hybrid swaps are declining over time. In such cases where the allocation of a particular uncleared swap to a specific asset class is not certain, the Commission expects an allocation to be made based on whichever broad asset class represents the preponderance of the uncleared swap's overall risk profile.

Second, a product-level initial margin model is well aligned with current practice for cleared swaps. Some clearinghouses that offer multiple swaps for clearing, such as the CME, do allow for risk offsets within an asset class but do not generally allow for any risk offsets across asset classes. Again, as a specific example, the CME offers both cleared interest rate and credit default swaps. The CME's initial margin model is a highly sophisticated risk management model that does allow for offsetting among different credit swaps and among different interest rate swaps but does not allow for risk offsets between interest rate and credit swaps. This approach to calculating initial margin also provides a significant amount of transparency as market participants, regulators and the public can assess the extent to which trading activity in specific asset classes generates counterparty exposures that require initial margin.

To the extent that some risk factors may cut across more than one asset class, the use of a risk factor-based margining approach would make evaluating the quantum of risk posed by the trading activity in any one set of products difficult to measure and manage on a systematic basis. This would also pose significant challenges to users of uncleared swaps as well as regulators and the broader public who have an interest in monitoring and evaluating the risks of different uncleared swap activities.

Third, the Commission notes that the final rule's product-level approach to initial margin explicitly allows for risk offsets though the precise form of these offsets differs from a "risk factor" based approach. The Commission believes that conceptually sound and empirically justified risk offsets for initial margin are appropriate and have included such offsets in the final rule. In general, there are a large number of possible approaches that could be taken to allow for such offsets. The Commission considered the alternatives raised by the commenters and adopted in the final rule an approach recognizing risk offsets that provides for a significant amount of hedging and diversification benefits while promoting transparency and simplicity in the margining framework.

Finally, the Commission notes that it may not have the authority to prescribe margin requirements for all the types of products that may be included in an ENMA. For example, the Commission's authority to set margin requirements relates to certain types of swaps and does not extend to other products such as equity-linked swaps or similar financial instruments. Accordingly, the Commission believes that the margin requirements should be reflective of the risks in a CSE's portfolio of uncleared swaps but may not recognize risks – either as offsets or sources of additional risk from other products that are themselves not uncleared swaps and not subject to the margin requirements of the final rule.

(iii) Stress calibration and non-linear price characteristics

The proposed rule required the initial margin model to be calibrated to a period of financial stress. In addition, the proposal requires the model to use risk factors sufficient to measure all material price risks inherent in the transactions for which initial margin is being calculated. Under the proposal, the initial margin model would have been required to include all material risks arising from the nonlinear price characteristics of option positions or positions with embedded optionality and the sensitivity of the market value of the positions to changes in the volatility of the underlying rates, prices, or other material risk factors.

One commenter suggested that the overall level of the proposed initial margin requirements were too high and that the proposed requirement to calibrate the initial margin model to a period of financial stress was too conservative.[203] Another commenter supported the stress period calibration requirement.[204] A third commenter asked for clarification on the term "period of financial stress."[205]

Some commenters suggested that the proposal's requirement that the initial margin model include all material nonlinear price characteristics in the underlying uncleared swap was too stringent and should be relaxed,[206] while one commenter applauded the requirement to include risk from nonlinearities.[207] One commenter argued

[203] MetLife
[204] See AFR.
[205] See Barnard.
[206] JBA, ISDA.
[207] See AFR.

that the initial margin model should incorporate the cost of liquidating large portfolios during periods of stress as well as volatility floors to guarantee a minimum level of volatility assumed.[208]

As noted, the final rule requires the initial margin model to be calibrated to a period of financial stress.[209] In particular, the initial margin model must employ a stress period calibration for each broad asset class (commodity, credit, equity, and interest rate and foreign exchange). The stress period calibration employed for each broad asset class must be appropriate to the specific asset class in question. While a common stress period calibration may be appropriate for some asset classes, a common stress period calibration for all asset classes would be considered appropriate only if it is appropriate for each specific underlying asset class. Also, the time period used to inform the stress period calibration must include at least one year, but no more than five years of equally-weighted historical data.

The final rule's requirement is intended to balance the tradeoff between shorter and longer data spans. Shorter data spans are sensitive to evolving market conditions but may also overreact to short-term and idiosyncratic spikes in volatility. Longer data spans are less sensitive to short-term market developments but may also place too little emphasis on periods of financial stress, resulting in insufficient initial margins. The requirement that the data be equally weighted will establish a degree of consistency in initial margin model calibration while also ensuring that particular weighting schemes do not result in excessive initial margin requirements during short-term bouts of heightened volatility.

[208] See CME.
[209] See final rule § 23.154(b)(2)(ii).

Calibration to a stress period helps to ensure that the resulting initial margin requirement is sufficient in a period of financial stress during which swap entities and financial end user counterparties are more likely to default, and counterparties handling a default are more likely to be under pressure. The stress calibration requirement also reduces the systemic risk associated with any increase in initial margin requirements that might occur in response to an abrupt increase in volatility during a period of financial stress, as initial margin requirements will already reflect a historical stress event.

The Commission continues to believe that the overall level of the initial margin requirements is consistent with the goals of prescribing margin requirements that are appropriate for the risk of uncleared swaps and the safety and soundness of the CSE. Moreover, the requirement to calibrate the initial margin model to a period of financial stress has two important benefits. First, initial margin requirements that are consistent with a period of financial stress will help to ensure that counterparties are sufficiently protected against the type of severe financial stresses that are most likely to have systemic consequences. Second, calibrating initial margins to a period of financial stress should have the effect of reducing the extent to which margin changes increase stress.

Specifically, because initial margin levels will be consistent with a period of above average market volatility and risk, a moderate rise in risk levels should not require any increase or re-evaluation of initial margin levels. In this sense, initial margin requirements will be less likely to increase abruptly following a market shock. There may be circumstances in which the financial system experiences a significant financial stress that is even greater than the stress to which initial margins have been calibrated. In these cases, initial margin requirements will rise as margin levels are re-calibrated to be consistent with the new and greater stress level. The Commission expects such occurrences to be relatively infrequent and, ultimately, any risk sensitive and empirically based method for calibrating a risk model must exhibit some sensitivity to changing financial market risks and conditions.

The Commission has decided to retain in the final rule the requirement that initial margin models must include all material nonlinear risks. The Commission is concerned that the uncleared swap market will be comprised of a large number of complex and customized swaps that will display significant nonlinear price characteristics that will have a direct effect on their risk exposure. If the models did not take these into account the initial margin amount collected would be inadequate to cover the swap's or swap portfolio's potential future exposure. Accordingly, the final rule requires that all material nonlinear price characteristics of an uncleared swap be considered in assessing the risk of the swap.

There may be nonlinear price characteristics of a particular uncleared swap that are not material in assessing its risk profile. In such cases, these nonlinear price characteristics need not be explicitly included in the initial margin model. The Commission expects that in determining whether or not a given nonlinear price characteristic is material, CSEs will engage in a holistic review of the uncleared swap's risk profile and make determinations based on the totality of the uncleared swap's risks.

(iv) Frequency of Margin Calculation

The proposed rule required daily calculation of initial margin. The use of an approved initial margin model may result in changes to the initial margin amount on a daily basis.

One commenter argued that the Commission should follow the approach of the European Union and require parties to establish procedures for adjusting initial margin requirements in response to changing market conditions.[210] Another commenter sought clarification that the initial margin calculation under a model would occur once daily based on the prior day's prices.[211]

The final rule retains the requirement that an approved initial margin model be used to calculate the required initial margin collection amount on a daily basis. As discussed below, the Commission believes that swap portfolios and the variables that are used to calculate the amount of initial margin on those swaps are constantly changing. Therefore, to ensure the adequacy of the amount of initial margin the Commission is requiring daily calculation. In cases where the initial margin collection amount increases, this new amount must be used as the basis for determining the amount of initial margin that must be collected from a financial end user with material swaps exposure or a swap entity counterparty.

In addition, when a CSE faces a financial end user with material swaps exposure, the CSE must also calculate the initial margin collection amount from the perspective of its counterparty on a daily basis. In the event that this amount increases, the CSE must use this new amount as the basis for determining the amount of initial margin that it must post to its counterparty. In cases where this amount decreases, the new amount would represent the new minimum required amount of initial margin. Accordingly, any

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[210] See Sifma (these procedures allow the counterparties to post increased margin requirements resulting from the recalibration of a model over a period longer than one day).
[211] See MFA (suggesting also that the Commission should modify the timing of recalculation to focus on the time at which a collateral taker makes a demand for transfer of collateral and provide that such transfer must be made promptly following the demand).

previously collected or posted collateral in excess of this amount would represent additional initial margin collateral that, subject to bilateral agreement, could be returned.

The use of an approved initial margin model may result in changes to the initial margin collection amount on a daily basis for a number of reasons. First, the characteristics of the swaps that have a material effect on their risk may change over time. As an example, the credit quality of a corporate reference entity upon which a credit default swap contract is written may undergo a measurable decline. A decline in the credit quality of the reference entity would be expected to have a material impact on the initial margin model's risk assessment and the resulting initial margin collection amount.

More generally, as the swaps' relevant risk characteristics change, so will the initial margin collection amount. In addition, any change to the composition of the swap portfolio that results in the addition or deletion of swaps from the portfolio will result in a change in the initial margin collection amount.

Second, the underlying parameters and data that are used in the model may change over time as underlying conditions change. As an example, in the event that a new period of financial stress is encountered in one or more asset classes, the initial margin model's risk assessment of a swap's overall risk may also change. While the stress period calibration is intended to reduce the extent to which small or moderate changes in the risk environment influence the initial margin model's risk assessment, a significant change in the risk environment that affects the required stress period calibration could influence the margin model's overall assessment of the risk of a swap.

Third, quantitative initial margin models are expected to be maintained and refined on a continuous basis to reflect the most accurate risk assessment possible with available best practices and methods.[212] As best practice risk management models and methods change, so too may the risk assessments of initial margin models.

(v) Benchmarking

The proposed rule required a model used for calculating initial margin requirements to be benchmarked periodically against observable margin standards to ensure that the initial margin required is not less than what a CCP would require for similar transactions.[213]

While one commenter supported the benchmarking requirement,[214] other commenters urged the Commission to remove the benchmarking requirement, noting the differences between model parameters and the availability of other risk-mitigating factors at a CSE, such as capital requirements that are not applicable to DCOs.[215] Another commenter suggested that any differences in initial margin requirements for cleared and uncleared swaps should be limited to the amount necessary to reflect counterparty credit risk.[216]

The Commission is retaining the benchmarking requirements. This benchmarking requirement is intended to ensure that any initial margin amount produced by a model is subject to a readily observable minimum. It will also have the effect of limiting the

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[212] Section 23.154(b)(iii) of the final rule would require any material change to the model be communicated to the Commission before taking effect. The Commission, however, anticipates that some changes will be made to initial margin models on an ongoing basis consistent with regular and ongoing maintenance and oversight that will not require Commission notification.
[213] Proposed § 23.154(b)(5).
[214] See CME.
[215] See ISDA; Sifma.
[216] See MetLife.

extent to which the use of models might disadvantage the movement of certain types of swaps to DCOs by setting lower initial margin amounts for uncleared transactions than for similar cleared transactions.

(d). Control Mechanisms

(i). Proposal

The proposal would have required CSEs to implement certain control mechanisms.[217] They include, among others, the following.

The CSE must maintain a risk management unit in accordance with existing Commission Regulation 23.600(c)(4)(i) that reports directly to senior management and is independent from the business trading units.[218] The unit must validate its model before implementation and on an ongoing basis. The validation process must include an evaluation of the conceptual soundness of the model, an ongoing monitoring process to ensure that the initial margin is not less than what a DCO would require for similar cleared products, and back testing.

If the validation process revealed any material problems with the model, the CSE would be required to notify the Commission of the problems, describe to the Commission any remedial actions being taken, and adjust the model to insure an appropriate amount of initial margin is being calculated.

The CSE must have an internal audit function independent of the business trading unit that at least annually assesses the effectiveness of the controls supporting the model.

[217] Proposed § 23.154(b)(5).

[218] Commission Regulation 23.600 requires each registered SD/MSP to establish a risk management program that identifies the risks implicated by the SD/MSP's activities along with the risk tolerance limits set by the SD/MSP. The SD/MSP should take into account a variety of risks, including market, credit, liquidity, foreign currency, legal, operational, settlement, and other applicable risks. The risks would also include risks posed by affiliates. See 17 CFR 23.600.

The internal audit function must report its findings to the CSE's governing body, senior management, and chief compliance officer at least annually.

(ii). Comments

Some commenters suggested that the model governance, control and oversight standards of the proposed rule were too strict and should not be so closely aligned with the model governance requirements for bank capital models.[219] One commenter suggested that since initial margin amounts must be agreed to between counterparties, it is not practical to require strict model governance standards.[220] Another commenter suggested that the initial margin model not be required to be back tested against the initial margin requirements for similar cleared swaps.[221] One commenter suggested that the frequency with which data must be reviewed and revised as necessary should be annual rather than monthly to better align with other aspects of the proposal that require certain governance processes to be conducted on an annual rather than monthly basis.[222] One commenter also cautioned against creating duplicative requirement for internal auditing since the effectiveness of initial and variation margin calculations are routinely and regularly evaluated as required in other Commission regulations.[223]

The Commission believes that strong model governance, oversight and control standards are crucial to ensuring the integrity of the initial margin model so as to provide for margin requirements that are commensurate with the risk of uncleared swaps. Moreover, the Commission is aware that there will be incentives to minimize the amount

[219] See JBA and SIFMA and IIB
[220] JBA.
[221] See SIFMA.
[222] See ISDA.; see also NERA.
[223] See BP (noting Commission Regulation 23.600).

of initial margin and that strong governance standards that are intended to result in strong and risk appropriate initial margin amounts is of critical importance.

In light of the clear competitive forces that will exist between cleared and uncleared swaps, the Commission believes that it is appropriate to compare the initial margin requirements of uncleared swaps to those of similar cleared swaps. Further, the Commission understands that comparable cleared swaps with observable initial margin standard may not always be available given the complexity and variety of uncleared swaps. Nevertheless, the Commission believes that where similar swaps trade on a cleared and uncleared basis such comparisons are useful and informative.

More specifically, under the final rule a CSE must periodically, and no less than annually, review its initial margin model in light of developments in financial markets and modeling technologies and make appropriate adjustments to the model. The Commission believes that harmonizing the frequency with which certain model governance processes must be performed will reduce the costs associated with the regular oversight and maintenance of the initial margin model without meaningfully altering the overall standards for model governance. Accordingly, the final rule requires that data used in the initial margin model be reviewed and revised as necessary, but at least annually rather than monthly to ensure that the data is appropriate for the products for which initial margin is being calculated. The Commission notes that different, additional or more granular data series may, at certain times, become available that would provide more accurate measurements of the risks that the initial margin model is intended to capture.

In addition to this regular review process, the final rule also requires that strong oversight, control and validation mechanisms be in place to ensure the integrity and validity of the initial margin model and related processes.  More specifically, the final rule requires that the model be independently validated prior to implementation and on an ongoing basis which would also include a monitoring process that includes back-tests of the model and related analyses to ensure that the level of initial margin being calculated is consistent with the underlying risk of the swap being margined.  Initial margin models must also be subject to explicit escalation procedures that would make any significant changes to the model subject to internal review and approval before taking effect.  Under the final rule, any such review and approval must be based on demonstrable analysis that the change to the model results in a model that is consistent with the requirements of the final rule.  Furthermore, under the final rule, any such changes or extensions of the initial margin model must be communicated to the Commission 60 days prior to taking effect to give the Commission the opportunity to rescind its prior approval or subject it to additional conditions.

The Commission also acknowledges that a CSE's internal audit department is required to routinely and regularly audit the effectiveness of initial and variation margin calculations.  The Commission believes that this requirement is necessary to ensure compliance with a minimum standard.

(e).  <u>Input from Counterparties</u>

The Commission received comments regarding counterparty inputs on a CSE's initial margin model.  One commenter urged the Commission to allow financial end users to have a role in determining the margin methodology used and suggested that CSEs should not be able to switch methodologies without the consent of the counterparty.[224] Other commenters suggested that the Commission require CSEs to disclose their initial margin models to non-CSE counterparties so that counterparties may validate the margin amount calculated[225] or otherwise allow financial end users access to the initial margin model and the inputs used by the CSE to allow them to challenge margin calls or demand the return of excess collateral during the life of a swap.[226]

The Commission notes that counterparties to a swap with a CSE have other mechanisms through which they could address their concerns without requiring a CSE to disclose its initial margin model methodologies. In particular, the Commission points to Commission Regulation 23.504(b)(4)(i) prescribing trade documentation requirements on counterparties. Specifically, Regulation 23.504(b)(4)(i) requires "written documentation in which the parties [to a swap] agree on the process, which may include any agreed upon methods, procedures, rules, and inputs, for determining the value of each swap at any time from execution to the termination, maturity, or expiration of such swap for purposes of complying with the margin requirements … and regulations …."[227] The Commission believes that the requirements on trade documentation specified in Regulation 23.504(b)(4)(i) should adequately address the concerns of commenters and is not prescribing more specific disclosure requirements with respect to internal initial margin models used by a CSE to its counterparties in the final rule.

3. Table-based Method

(a). Method of Calculation

[224] See GPC.
[225] See ICI; GPC; MFA.
[226] See FHLB.
[227] 17 CFR 23.504(b)(4)(i).

Some CSEs might not have the internal technical resources to develop initial margin models or have simple portfolios for which they want to avoid the complexity of modeling. The table-based method would allow a CSE to calculate its initial margin requirements using a standardized table.[228] The table specifies the minimum initial margin amount that must be collected as a percentage of a swap's notional amount. This percentage varies depending on the asset class of the swap. Except as modified by the net-to-gross ratio adjustment,[229] a CSE would be required to calculate a minimum initial margin amount for each swap and sum up all the minimum initial margin amounts calculated under this section to arrive at the total amount of initial margin. The table is consistent with international standards.[230]

(b). Comments

Two commenters suggested that the Commission adopt an altogether different approach to computing standardized initial margins in a manner consistent with the standardized approach for measuring counterparty credit risk exposures that was finalized and published by the Basel Committee on Banking Supervision in March 2014.[231] This approach is intended to be used in bank regulatory capital requirements for the purposes of computing capital requirements for counterparty credit risk resulting from OTC derivative exposures. A third commenter remarked that the table-based method should be modified to reflect greater granularity, including increasing the number of asset categories recognized by the standardized initial margin table.[232] Among other things,

[228] Proposed § 23.154(c).
[229] See 79 FR 59,898, at 59,911 (Oct. 3, 2014).
[230] BCBS/IOSCO Report at Appendix A.
[231] See JBA; CS.
[232] See MFA.

this commenter suggested increasing the number of asset categories recognized by the standardized initial margin table.

(c). Discussion

In the final rule, the Commission has adopted the proposed approach to standardized initial margin. The Commission has decided not to adopt a different approach advocated by the commenters in the final rule for several reasons. First, the standardized approach for counterparty credit risk has been developed for counterparty capital requirement purposes and, while clearly related to the issue of initial margin for uncleared swaps, it is not entirely clear that this framework can be transferred to a simple and transparent standardized initial margin framework without modification.

Second, the standardized approach that has been published by the Basel Committee on Banking Supervision is not intended to become effective until January 2017 which follows the initial compliance date of the final rule. Accordingly, the Commission expects that some form of the standardized approach will be proposed by U.S. banking regulators prior to January 2017. Following the notice and comment period, a final rule for capitalizing counterparty credit risk exposures will be finalized in the United States. Once these rules are in place and effective it may be appropriate to consider adjusting the approach in this rule to standardized initial margins. Prior to the new capital rules being effective in the United States for the purpose for which they were intended, the Commission does not believe it would be appropriate to incorporate the standardized approach to counterparty credit risk that has been published by the Basel Committee on Banking Supervision into the final margin requirements for uncleared swaps.

The Commission acknowledges the desire to reflect greater granularity in the standardized approach but also notes that the approach in the final rule distinguishes among four separate asset classes and various maturities. The Commission also notes that no commenter provided a specific and fully articulated suggestion on how to modify the standardized approach to achieve greater flexibility without becoming overly burdensome. The Commission also notes that the standardized initial margins are a minimum margin requirement. CSEs and their counterparties are free to develop standardized margin schedules that reflect greater granularity than the final rule's standardized approach so long as the resulting amounts would in all circumstances be at least as large as those required by the final rule's standardized approach to initial margin. Accordingly, the final rule affords CSEs and their counterparties the opportunity to develop simple and transparent margin schedules that reflect the granular and specific nature of the swap activity being margined.

Under the final rule, standardized initial margins depend on the asset class (commodity, equity, credit, foreign exchange and interest rate) and, in the case of credit and interest rate asset classes, further depend on the duration of the underlying uncleared swap. In addition, the standardized initial margin requirement allows for the recognition of risk offsets through the use of a net-to-gross ratio in cases where a portfolio of uncleared swaps is executed under an EMNA.

The net-to-gross ratio compares the net current replacement cost of the non-cleared portfolio (in the numerator) with the gross current replacement cost of the non-cleared portfolio (in the denominator). The net current replacement cost is the cost of replacing the entire portfolio of swaps that are covered under the EMNA. The gross current replacement cost is the cost of replacing those swaps that have a strictly positive replacement cost under the EMNA.

As an example, consider a portfolio that consists of two uncleared swaps under an EMNA in which the mark-to-market value of the first swap is $10 (i.e., the CSE is owed $10 from its counterparty) and the mark-to-market value of the second swap is -$5 (i.e., the CSE owes $5 to its counterparty). Then the net current replacement cost is $5 ($10-$5), the gross current replacement cost is $10, and the net-to-gross ratio would be 5/10 or 0.5.[233]

The net-to-gross ratio and gross standardized initial margin amounts (provided in § 23.154(c)) are used in conjunction with the notional amount of the transactions in the underlying swap portfolio to arrive at the total initial margin requirement as follows:

Standardized Initial Margin=0.4 x Gross Initial Margin + 0.6 x NGR x Gross Initial Margin

where:

Gross Initial Margin= the sum of the notional value multiplied by the appropriate initial margin requirement percentage from Appendix A of each uncleared swap under the EMNA; and

NGR= net-to-gross ratio

As a specific example, consider the two-swap portfolio discussed above. Suppose further that the swap with the mark-to-market value of $10 is a sold 5-year credit default

[233] Note that in this example, whether or not the counterparties have agreed to exchange variation margin has no effect on the net-to-gross ratio calculation, i.e., the calculation is performed without considering any variation margin payments. This is intended to ensure that the net-to-gross ratio calculation reflects the extent to which the uncleared swaps generally offset each other and not whether the counterparties have agreed to exchange variation margin. As an example, if a swap dealer engaged in a single sold credit derivative with a counterparty, then the net-to-gross calculation would be 1.0 whether or not the dealer received variation margin from its counterparty.

swap with a notional value of $100 and the swap with the mark-to-market value of -$5 is an equity swap with a notional value of $100. The standardized initial margin requirement would then 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 Commission further notes that the calculation of the net-to-gross ratio for margin purposes must be applied only to swaps subject to the same EMNA and that the calculation is performed across transactions in disparate asset classes within a single EMNA such as credit and equity in the above example. That is, all uncleared swaps subject to the same EMNA and subject to the final rule's requirements can net against each other in the calculation of the net-to-gross ratio, as opposed to the modeling approach that allows netting only within each asset class.

This approach is consistent with the standardized counterparty credit risk capital requirements. Also, the equations are designed such that benefits provided by the net-to-gross ratio calculation are limited by the standardized initial margin term that is independent of the net-to-gross ratio, i.e., the first term of the standardized initial margin equation which is 0.4 x Gross Initial Margin.

Finally, if a counterparty maintains multiple uncleared swap portfolios under one or multiple EMNAs, the standardized initial margin amounts would be calculated separately for each portfolio with each calculation using the gross initial margin and net-to-gross ratio that is relevant to each portfolio. The total standardized initial margin would be the sum of the standardized initial margin amounts for each portfolio.

The final rule's standardized approach to initial margin depends on the calculation of a net-to-gross ratio. In the context of performing margin calculations, it must be recognized that at the time uncleared swaps are entered into it is often the case that both the net and gross current replacement cost is zero. This precludes the calculation of the net-to-gross ratio. In cases where a new swap is being added to an existing portfolio that is being executed under an existing EMNA, the net-to-gross ratio may be calculated with respect to the existing portfolio of swaps. In cases where an entirely new swap portfolio is being established, the initial value of the net-to-gross ratio should be set to 1.0. After the first day's mark-to-market valuation has been recorded for the portfolio, the net-to-gross ratio may be re-calculated and the initial margin amount may be adjusted based on the revised net-to-gross ratio.

The final rule requires that the standardized initial margin collection amount be calculated on a daily basis. In cases where the initial margin collection amount increases, this new amount must be used as the basis for determining the amount of initial margin that must be collected from a financial end user with material swaps exposure or a swap entity. In addition, when a CSE faces a financial end user with material swaps exposure, the CSE must also calculate the initial margin collection amount from the perspective of its counterparty on a daily basis. In the event that this amount increases, the CSE must use this new amount as the basis for determining the amount of initial margin that it must post to its counterparty. In the event that this amount decreases, this new amount would also serve as the basis for the minimum required amount of initial margin. Accordingly, any previously collected or posted initial margin over and above the new requirement could, subject to bilateral agreement, be returned.

As in the case of internal-model-generated initial margins, the margin calculation under the standardized approach must also be performed on a daily basis. Because the standardized initial margin calculation depends on a standardized look-up table (in Regulation 23.154(c)), there are fewer reasons for the initial margin collection amounts to vary on a daily basis. However, there are some factors that may result in daily changes in the initial margin collection amount under the standardized margin calculations.

First, any changes to the notional size of the swap portfolio that arise from any addition or deletion of swaps from the portfolio would result in a change in the standardized margin amount. As an example, if the notional amount of the swap portfolio increased as a result of adding a new swap to the portfolio then the standardized initial margin collection amount would increase.

Second, changes in the net-to-gross ratio that result from changes in the mark-to-market valuation of the underlying swaps would result in a change in the standardized initial margin collection amount.

Third, changes to characteristics of the swap that determine the gross initial margin would result in a change in the standardized initial margin collection amount. As an example, the gross initial margin applied to interest rate swaps depends on the duration of the swap. An interest rate swap with a duration between zero and two years has a gross initial margin of one percent while an interest rate swap with duration of greater than two years and less than five years has a gross initial margin of two percent. Accordingly, if an interest rate swap's duration declines from above two years to below two years, the gross initial margin applied to it would decline from two to one percent. Accordingly, the standardized initial margin collection amount will need to be computed on a daily basis to reflect all of the factors described above.

F. Calculation of Variation Margin

1. Proposal

Under the proposal, each CSE would be required to calculate variation margin for itself and for each covered counterparty using a methodology and inputs that to the maximum extent practicable, and in accordance with existing Regulation 23.504(b)(4) rely on recently-executed transactions, valuations provided by independent third parties, or other objective criteria.[234] In addition, each CSE would need to have in place alternative methods for determining the value of an uncleared swap in the event of the unavailability or other failure of any input required to value a swap.[235]

Similar to the requirement for initial margin, the proposal would require each CSE to collect variation margin from, and to pay variation margin to, each counterparty that is a swap entity or a financial end user, on or before the end of the business day after execution for each swap with that counterparty.[236] The proposed rule required the CSEs to continue to pay or collect variation margin each business day until the swap is terminated or expires.[237]

The proposal would also set forth several control mechanisms.[238] Each CSE would be required to create and maintain documentation setting forth the variation margin methodology with sufficient specificity to allow the counterparty, the Commission, and any applicable Prudential Regulator to calculate a reasonable approximation of the margin requirement independently. Each CSE would be required to evaluate the reliability of its data sources at least annually, and to make adjustments, as

[234] Proposed § 23.155(a)(1) and current § 23.504(b)(4).
[235] Proposed § 23.155(a)(2).
[236] Proposed § 23.153(a).
[237] Proposed § 23.153(b).
[238] Proposed § 23.155(b).

appropriate. The proposal would permit the Commission to require a CSE to provide further data or analysis concerning the methodology or a data source.

2. Comments

Several commenters suggested that the Commission consider alternate methods for calculating variation margin.[239] Commenters stated that the proposal appeared to require a CSE to determine minimum variation margin requirements based on the market value of a swap calculated only from the CSE's own perspective, rather than at a mid-market price consistent with current market practice. These commenters urged that using mid-market swap values to determine variation margin would align more closely with industry practice and would not skew in favor of a CSE.[240] They also remarked that all calculations and methodologies should be available to counterparties.

Further, one commenter remarked that the requirements on the method for calculating variation margin is redundant because other Commission regulations already address variation margin calculation methodology.[241] Additionally, commenters also questioned the Commission's view of variation margin as a settlement or payment, noting for example concerns with the tax and accounting consequences.[242]

Many commenters urged the Commission to provide more time for the delivery of variation margin.[243] One commenter asked for clarification that the collection and calculation of variation margin would occur only once a day based on the closing price of

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[239] See MetLife; Sifma-AMG; Freddie; FHLB (parties should seek prices based on recently-executed transactions, valuations provided by independent third-parties or other objective criteria).
[240] These commenters argued that this approach would result in dealer exposures being over-collateralized and their counterparties' exposures being under-collateralized.
[241] See ISDA.
[242] See e.g., ACLI.
[243] See JFMC; GPC; and ISDA.

the previous day.[244] Another commenter argued that the frequency of posting variation margin (i.e., daily) could possibly create liquidity pressures and have pro-cyclicality effects.[245]

One commenter also suggested that CSEs should not be required to exchange variation margin with financial end users whose exposures to the CSE fall below the material swaps exposure threshold.[246]

3. Discussion

After carefully reviewing the comments, the Commission is adopting the variation margin requirement largely as proposed, but with a limited number of changes to address concerns raised by commenters with respect to the calculation and exchange of variation margin.

When a CSE engages in an uncleared swap transaction with a financial end user, regardless of whether or not the financial end user has a material swaps exposure, the final rule will require the CSE to collect and post variation margin with respect to the uncleared swap. The final rule requires a CSE to collect or to post (as applicable) variation margin on uncleared swaps in an amount that is at least equal to the increase or decrease (as applicable) in the value of such swaps since the previous exchange of variation margin.

Consistent with the proposal, a CSE may not establish a threshold amount below which it need not exchange variation margin on swaps with a swap entity or financial end

[244] See MFA.
[245] See NERA.
[246] See ISDA.

user counterparty (although transfers below the minimum transfer amount would not be required).

The Commission believes the bilateral exchange of variation margin will support CSE safety and soundness as well as effectively reduce systemic risk by protecting both the CSE and its counterparty from the effects of a counterparty default.

Unlike the proposal, which used the terms “pay” and “paid” to refer to the transfer of variation margin, the final rule refers to variation margin in terms of “post” and “collect.” After carefully reviewing the comments on the proposal that addressed the appropriate characterization of the transfer of variation margin, the Commission has determined that it is more appropriate to refer to variation margin collateral as having been “posted,” rather than “paid,” consistent with the treatment of initial margin.

Among the reasons underlying the Commission’s proposal to refer to variation margin in terms of payment, was the existing market practice of swap dealers to exchange variation margin with other swap dealers in the form of cash. As is discussed below in the final rule’s provisions on eligible collateral, the Commission has concluded that it is appropriate to permit financial end users to use other, non-cash forms of collateral for variation margin. This revision to the nomenclature of the final rule is consistent with the Commission’s inclusion of eligible non-cash collateral for variation margin.

In the context of cash variation margin, commenters also expressed concerns that the Commission’s choice of the “pay” nomenclature reflected an underlying premise of current settlement that may be inconsistent with various operational, accounting, tax, legal, and market practices. The Commission’s use of the “post” and “collect” nomenclature for the final rule is not intended to reflect upon or alter the characterization of variation margin exchanges – either as a transfer and settlement or a provisional form of collateral – for other purposes in the market.

Under the final rule, "variation margin" means the collateral provided by one party to its counterparty to meet the performance of its obligations under one or more uncleared swaps between the parties as a result of a change in value of such obligations since the last time such collateral was provided.[247] The amount of variation margin to be collected or posted (as appropriate) is the amount equal to the cumulative mark-to-market change in value to a CSE of an uncleared swap, as measured from the date it is entered into (or, in the case of an uncleared swap that has a positive or negative value to a CSE on the date it is entered into, such positive or negative value plus any cumulative mark-to-market change in value to the CSE of a uncleared swap after such date), less the value of all variation margin previously collected, plus the value of all variation margin previously posted with respect to such uncleared swap.[248] The CSE must collect this amount if the amount is positive, and post this amount if the amount is negative.

The Commission wishes to clarify that the reference in the rule text to the "cumulative mark-to-market change in value to a CSE of an uncleared swap" is not designed or intended to have the effect suggested by commenters. The market value used to determine the cumulative mark-to-market change will be mid-market prices, if that is consistent with the agreement of the parties.[249] The final rule is consistent with

[247] § 23.155.
[248] § 23.151.
[249] Additionally, the Commission notes that the final margin requirements should be viewed as minimums. To the extent that two counterparties agree to transfer collateral in addition to the minimum amount required by the final rule, the final rule will not impede them.

market practice in this respect. The rule text's reference to "change in value to a covered swap entity" refers to whether the value change is positive or negative from the CSE's standpoint. This ties to the final rule's requirement for the CSE to post variation margin when the variation margin amount is positive, or to collect variation margin when the variation margin amount is negative.

In calculating variation margin amounts, the final rule permits netting across a portfolio of uncleared swaps between the CSE and a particular counterparty, subject to a number of conditions. These provisions are discussed in more detail above.

Consistent with the proposal, the final rule requires a CSE to exchange variation margin for uncleared swaps with swap entities and financial end users (regardless of whether the financial end user has a material swaps exposure). However, as discussed earlier, the enactment of TRIPRA exempts certain nonfinancial counterparties from the scope of this rulemaking for uncleared swaps that hedge or mitigate commercial risk.[250] The Commission is not requiring that CSEs exchange variation margin with respect to the swaps that are exempted from the margin final rule by TRIPRA.

Overall, this aspect of the variation margin provisions of the final rule is consistent with the approach for initial margin. The final rule largely retains the proposed rule's requirement for variation margin to be posted or collected on a T+1 timeframe. The final rule requires variation margin to be posted or collected no less than once per business day, beginning on the business day following the day of execution. These provisions of the final rule operate in the same way as those discussed earlier in the description of the final rule's initial margin requirements.

[250] The Commission is not requiring that CSEs collect initial or variation margin from these so-called "commercial end user" counterparties.

The one difference is that all transactions with financial end user counterparties are subject to the variation margin requirements, while only financial end user counterparties with material swaps exposure are subject to initial margin requirements. The Commission believes it is appropriate to apply the minimum variation margin requirements to non-exempted transactions with all financial entity counterparties, not just those with a material swaps exposure, because the daily exchange of variation margin is an important risk mitigant that (i) reduces the build-up of risk that may ultimately pose systemic risk; (ii) does not, in aggregate, reduce the amount of liquid assets readily available to posting and collecting entities because it simply transfers resources from one entity to another; and (iii) reflects both current market practice and a risk management best practice.

The final rule in this area is consistent with that of the Prudential Regulators but is more detailed in one respect.  The Commission's rule requires that variation margin calculations use methods, procedures, rules, and inputs that, to the maximum extent practicable rely on recently-executed transactions, valuations provided by independent third parties, or other objective criteria.

The Commission believes that the accurate valuation of positions is a critical element in assuring the safety and soundness of CSEs and in preserving the integrity of the financial system.  The standard set forth in the Commission's rule is consistent with recently-issued international standards.[251]

G.  Forms of Margin

1.  Initial Margin

[251] Risk Mitigation Standards for Non-centrally Cleared OTC Derivatives, International Organization of Securities Commissions (January 28, 2015).

(a). Proposal

In general, the Commission believes that margin assets should share the following fundamental characteristics. The assets should be liquid and, with haircuts, hold their value in times of financial stress. The value of the assets should not exhibit a significant correlation with the creditworthiness of the counterparty or the value of the swap portfolio.[252]

Guided by these principles, the Commission proposed that CSEs may only post or accept certain assets to meet initial margin requirements to or from covered counterparties.[253] These are assets for which there are deep and liquid markets and, therefore, assets that can be readily valued and easily liquidated.

Certain assets would be prohibited from use as initial margin because the Commission was concerned that the use of those assets could compound risk.[254] These included any asset that is an obligation of the party providing such asset or an affiliate of that party. These also include instruments issued by bank holding companies, depository institutions, and market intermediaries. These restrictions reflected the Commission's view that the price and liquidity of securities issued by the foregoing entities are very likely to come under significant pressure during a period of financial stress when a CSE may be resolving a counterparty's defaulted swap position and, therefore, present an additional source of risk.

(b). Comments

[252] See BCBS/IOSCO Report at 16.
[253] Proposed § 23.156(a)(1).
[254] Proposed § 23.156(a)(2).

Commenters generally supported the Commission's proposed asset categories or sought limited modifications. Several commenters argued in support of including other assets (such as interests in money market funds and high quality liquid debt securities) in the list of eligible collateral or allowing parties to negotiate acceptable forms of collateral.[255] Commenters who asked the Commission to consider GSE securities as eligible collateral for variation margin joined many others who opposed limiting variation margin collateral to cash only.

Commenters representing the interests of asset managers, mutual funds, and other institutional asset managers asked the Commission to expand the list of eligible collateral to include money market mutual funds and bank certificates of deposit, in the interests of providing financial end users with a higher yield than cash held by the margin custodian and more liquidity than direct holdings of government or corporate bonds. Some commenters requested that bank certificates of deposit be considered eligible collateral for margin purposes.

Commenters stated that GSE debt securities already are widely used as collateral for uncleared swaps and should continue to be eligible under the final rule given their historically low levels of volatility. A smaller number of the commenters argued that GSE mortgage-backed securities ("MBS") also should be eligible collateral given that markets have accepted GSE MBS as liquid, high-quality securities along with other GSE debt. A number of commenters suggested that GSE debt securities and MBS should qualify as eligible collateral, regardless of whether or not the GSE is operating with capital support or another form of financial assistance from the United States.

[255] See ICI; ISDA; CPFM; GPC; Sifma-AMG; IECA (letters of credit); Freddie; and CDEU.

Some commenters also questioned why the minimum haircut for debt securities of GSEs (operating without capital support or other financial assistance from the U.S) is not lower than the minimum haircuts applicable to corporate debt. Another concern that some commenters raised is that the capital and margin rule for uncleared swaps is inconsistent in its treatment of GSE securities with the liquidity coverage ratio rule that the Board, OCC, and FDIC issued in 2014.[256]

One commenter cautioned against classifying the debt securities of federal home loan banks as eligible collateral and stated that asset-backed securities issued by a U.S. Government-sponsored enterprises ("GSE") should not be precluded from the list of eligible collateral solely because those securities are not unconditionally guaranteed by a GSE whose obligations are fully guaranteed by the U.S. government.[257] Another commenter cautioned against including equities in the list of eligible collateral because of their inherent risky nature.[258] Commenters also suggested that the Commission allow parties to model haircuts for eligible collateral.[259]

Commenters also requested that the Commission provide guidance about the rule's application to current market practice incorporating contractual provisions specifying an agreed-upon currency of settlement, transport, transit currencies and termination currencies. Additionally, commenters urged the Commission to permit any cross-currency sensitivity between the swap portfolio credit exposure and the margin

[256] See 79 FR 61439 (October 10, 2014) (Liquidity Coverage Ratio: Liquidity Risk Measurement Standards).

[257] See FHLB.

[258] See Barnard.

[259] See ISDA; Sifma.

collateral provided against that exposure to be measured as a component of the margin required to be exchanged under the rule.

Finally, some commenters urged the Commission to perform annual reviews of the eligible collateral categories and the haircuts.[260]

(c). Discussion

With respect to initial margin, the final rule includes an expansive list of the types of collateral that is largely consistent with the list set forth in the proposal. Eligible collateral for initial margin includes immediately available cash funds denominated in any major currency or the currency of settlement, debt securities that are issued or guaranteed by the U.S. Department of Treasury or by another U.S. government agency, the Bank for International Settlements, the International Monetary Fund, the European Central Bank, multilateral development banks, certain GSEs' debt securities, certain foreign government debt securities, certain corporate debt securities, certain listed equities, shares in certain investment funds, and gold.

The Commission is including equities as eligible collateral in the final rule, with the requirement for a minimum 15 percent haircut on equities in the S&P 500 Index and a minimum 25 percent haircut for those in the S&P 1500 Composite Index but not in the S&P 500 Index.[261] The Commission notes that, even with these restrictions designed to address liquidity and volatility, CSEs should also take concentrations into account, and prudently manage their acceptance of initial margin collateral, with the idiosyncratic risk of equity – and publicly traded debt – issuers in mind. The Commission notes that it is

[260] As with all of its rules, the Commission will make appropriate changes if it believes it is necessary.
[261] Although equities included in the S&P 500 Index are also included in the S&P 1500 Composite Index, equities in the S&P 500 Index are subject to the 15 percent minimum haircut, not the 25 percent minimum haircut.

important to consider longer time periods incorporating periods of market stress, and the minimum haircuts are calibrated accordingly.

To accommodate the concern of certain commenters that argued for an inclusion of money market mutual funds and bank certificates of deposit in the list of eligible collateral for initial margin and to provide flexibility while maintaining a level of safety, the final rule adds redeemable securities in a pooled investment fund that holds only securities that are issued by, or unconditionally guaranteed as to the timely payment of principal and interest by, the U.S. Department of the Treasury, and cash funds denominated in U.S. dollars. To provide a parallel collateral option for uncleared swap portfolios in denominations other than U.S. dollars, the pooled investment fund may be structured to invest in pool of securities that are denominated in a common currency and issued by, or fully guaranteed as to the timely payment of principal and interest by, the European Central Bank or a sovereign entity that is assigned no higher than a 20 percent risk weight under applicable regulatory capital rules, and cash denominated in the same currency.

The final rule requires these pooled investment vehicles to issue redeemable securities representing the holder's proportional interest in the fund's net assets, issued and redeemed only on the basis of the fund's net assets prepared each business day after the holder makes its investment commitment or redemption request to the fund. These criteria are similar to those used for bank trust department common trust funds and common investment funds, to facilitate liquidity of the redeemable securities while still protecting holders of the fund's securities from dilution. The final rule also provides that assets of the fund may not be transferred through securities lending, securities borrowing, reverse repurchase agreements, or similar arrangements. This is to ensure consistency with the prohibition under the final rule against custodian rehypothecation of initial margin collateral.

Consistent with the proposal, the final rule generally does not include asset-backed securities ("ABS"), including MBS, within the permissible category of publicly-traded debt securities. However, ABS are included as eligible collateral if they are issued by, or unconditionally guaranteed as to the timely payment of principal and interest by, the U.S. Department of the Treasury or another U.S. government agency whose obligations are fully guaranteed by the full faith and credit of the United States government; or if they are fully guaranteed by a U.S. GSE that is operating with capital support or another form of direct financial assistance received from the U.S. government that enables repayment of the securities.

Publicly traded debt securities (that are not ABS) issued by GSEs are included in eligible collateral as long as the issuing GSE is either operating with capital support or another form of direct financial assistance received from the U.S. government that enables full repayment of principal and interest on these securities, or the CSE determines the securities are "investment grade" (as defined by the appropriate prudential regulator).

Although the Commission received several comments concerning the proposal's treatment of GSE securities, only modest changes have been made in the final rule. In the final rule, the Commission recognizes the unique nature of GSE securities by placing them in a category separate from both securities issued directly by U.S. government agencies and those from non-GSE, private sector issuers. However, the Commission continues to believe the final rule should treat GSE securities differently depending on whether or not the GSE enjoys explicit government support, in the interests of both the safety and soundness of CSE and the stability of the financial system.

GSE debt obligations are not explicitly guaranteed by the full faith and credit of the U.S. government. Existing law, however, authorizes the United States Treasury to provide lines of credit, up to a specified amount, to certain GSEs in the event they face specific financial difficulties. An act of Congress would be required to provide adequate support if, for example, a GSE were to experience severe difficulty in selling its securities in financial markets because investors doubted its ability to meet its financial obligations.[262] The treatment of GSE securities by market participants as if those securities were nearly equivalent to Treasury securities in the absence of explicit Treasury support creates a potential threat to financial market stability, especially if vulnerabilities arise in markets where one or more GSEs are dominant participants, as occurred during the summer of 2008.

The final rule's differing treatment of GSE collateral based on whether or not the GSE has explicit support of the U.S. government helps address this source of potential financial instability and recognizes that securities issued by an entity explicitly supported by the U.S. government might well perform better during a crisis than those issued by an entity operating without such support. The final rule adopts the approach that was used in the proposed rule and assigns the same minimum haircut to both corporate obligations and the debt securities of GSEs that are operating without capital support or another form of financial assistance from the U.S. From the Commission's perspective, this approach

[262] Congress provided such support with the passage of the Agricultural Credit Act of 1987 and with the Housing and Economic Recovery Act of 2008.

facilitates appropriate due diligence when a party considers the creditworthiness of a GSE security that it may accept as collateral.

The final rule retains the 2014 proposal's provision excluding any securities issued by the counterparty or any of its affiliates. To avoid the compounding of risk, the final rule continues to exclude securities issued by 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, or an affiliate of one of the foregoing institutions. For the same reason, the Commission has expanded this restriction in the final rule also to exclude securities issued by a non-bank systemically important financial institution designated by the Financial Stability Oversight Council. These entities are financial in nature and, like banks or market intermediaries, would be expected to come under significant financial stress in the event of a period of financial stress. Accordingly, the Commission believes that it is also appropriate to restrict securities issued by these entities as eligible margin collateral to ensure that collected collateral is free from significant sources of this type of risk.

The final rule does not allow a CSE to fulfill the rule's minimum margin requirements with any assets not included in the eligible collateral list, which is comprised of assets that should remain liquid and readily marketable during times of financial stress. The use of alternative types of collateral to fulfill regulatory margin requirements would introduce concerns that the changes in the liquidity, price volatility, or other risks of collateral during a period of financial stress could exacerbate that stress) and could undermine efforts to ensure that collateral is subject to low credit, market, and liquidity risk. Therefore, the final rule limits the recognition of margin collateral to the aforementioned list of assets. Counterparties that wished to rely on assets that do not qualify as eligible collateral under the proposed rule still would be able to pledge those assets with a lender in a separate arrangement, such as collateral transformation arrangements, using the cash or other eligible collateral received from that separate arrangement to meet the minimum margin requirements.

The Commission wishes to note here that because the value of noncash collateral and foreign currency may change over time, the proposal would require a CSE to monitor the value of such collateral previously collected to satisfy initial margin requirements and, to the extent the value of such collateral has decreased, to collect additional collateral with a sufficient value to ensure that all applicable initial margin requirements remain satisfied on a daily basis.[263]

Moreover, the Commission notes that the proposal would not restrict the types of collateral that could be collected or posted to satisfy margin terms that are bilaterally negotiated above required amounts. For example, if, notwithstanding the $50 million threshold, a CSE decided to collect initial margin to protect itself against the credit risk of a particular counterparty, the CSE could accept any form of collateral.

2. Variation margin

(a). Proposal

The proposal would require that variation margin be paid in U.S. dollars, or a currency in which payment obligations under the swap are required to be settled.[264] When determining the currency in which payment obligations under the swap are

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[263] Proposed § 23.156(a)(4).
[264] Proposed § 23.156(b).

required to be settled, a CSE would be required to consider the entirety of the contractual obligation. For example, in cases where a number of swaps, each potentially denominated in a different currency, are subject to a single master agreement that requires all swap cash flows to be settled in a single currency, such as the Euro, then that currency (Euro) may be considered the currency in which payment obligations are required to be settled.

Under this proposed rule, the value of cash paid to satisfy variation margin requirements is not subject to a haircut.

(b). Comments

The Commission received a large number of comments arguing for the broadening of the list of eligible collateral for variation margin to include noncash assets.[265] These commenters generally argued that limiting variation margin to cash is inconsistent with current market practice for financial end users, is incompatible with the 2013 international framework agreement, and would drain the liquidity of these financial end users by forcing them to hold more cash. The same commenters suggested including securities such as U.S. Treasuries or other government bonds.

While some commenters representing public interest groups favored limiting variation margin exchanged between CSEs to cash, some commenters representing the financial sector expressed concern that regulators in other key market jurisdictions have not proposed comparable variation margin restrictions. Commenters also asked the Commission to consider GSE securities as eligible collateral for variation margin.

[265] See ICI; JFMC; ISDA; CCRM; CPFM; Sifma; MetLife; GPC; Sifma-AMG; ABA; JBA; AIMA; MFA; FSR; Freddie; CDEU; FHLB; ACLI; NERA; and TIAA-CREF. However, commenters representing public interest groups generally favored the proposed approach.

One commenter asked for clarification on whether a haircut applies if variation margin is paid in the currency in which the swap is denominated.[266] Another commenter asked for confirmation that a cash payment of variation margin would not be subject to any haircuts.[267] One commenter also proposed that the Commission grant the counterparties the flexibility to specify a base currency in their counterparty agreements on a case-by-case basis.[268]

(c). Discussion

With respect to variation margin, the proposal would have limited eligible collateral to immediately available cash funds, denominated either in U.S. dollars or in the currency in which payment obligations under the uncleared swap are required to be settled. However, after reviewing comments from financial end users of derivatives, such as insurance companies, mutual funds, and pension funds, the Commission has expanded the list of eligible variation margin for uncleared swaps between a CSE and financial end users. These commenters generally argued that limiting variation margin to cash is inconsistent with current market practice for financial end users; is incompatible with the 2013 international framework agreement; and would drain the liquidity of these financial end users by forcing them to hold more cash. In response to these comments, the final rule permits assets that are eligible as initial margin to also be eligible as variation margin for swap transactions between a CSE and financial end user, subject to the applicable haircuts for each type of eligible collateral.

[266] See JBA.
[267] See ISDA.
[268] See CPFM.

This change aligns the rule more closely with current market practice. Commenters indicated many types of financial end users exchange variation margin with their swap dealers in the form of non-cash collateral that consists of their investment assets. This practice permits them to maximize their investment income and minimize margin costs, even though these assets are subject to valuation haircuts when posted as variation margin.

The Commission notes however (as described in the 2014 proposal) that most of the variation margin by total volume continues to be in the form of cash exchanged between SDs. Therefore, consistent with the proposal, variation margin exchanged by a CSE with another swap entity must be in the form of immediately available cash. The Commission continues to believe that limiting variation margin exchanged between a CSE and a swap entity to cash is consistent with regulatory and industry initiatives to improve standardization and efficiency in the OTC swaps market. Swap entities have access to cash, and its continued use as variation margin between swap entities will reduce the potential for disputes over the value of variation margin collateral, due to the absence of associated market and credit risks. Also, in periods of severe market stress, the ultimate liquidity of cash variation margin exchanged between CSEs – which occupy a key position to provide and maintain trading liquidity in the market for uncleared swaps – should assist in preserving the financial integrity of that market and the stability of the U.S. financial system.

However, for reasons discussed below, the Commission is revising the final rule to expand the denominations of immediately available cash funds that are eligible.

Whereas the proposal only recognized U.S. dollars or the currency of settlement, the final rule expands the category to include any major currency.[269]

3. Currency of Settlement, Collateral Valuation, and Haircuts

For those assets whose values may show volatility during times of stress, the final rule imposes an 8 percent cross-currency haircut, and standardized prudential supervisory haircuts that vary by asset class. When determining how much collateral will be necessary to satisfy the minimum initial margin requirement for a particular transaction, a CSE must apply the relevant standardized prudential supervisory haircut to the value of the eligible collateral. The final rule's haircuts guard against the possibility that the value of non-cash eligible margin collateral could decline during the period between when a counterparty defaults and when the CSE closes out that counterparty's swap positions.

The Commission has revised the cross-currency haircut applicable to eligible collateral under the final rule. The cross-currency haircut will apply whenever the eligible collateral posted (as either variation or initial margin) is denominated in a currency other than the currency of settlement, except that variation margin in immediately available cash funds in any major currency is never subject to the haircut. The amount of the cross-currency haircut remains 8 percent, as it was in the proposal.

The Commission has decided to eliminate the haircut on variation margin provided in immediately available cash funds denominated in all major currencies because the cash funds are liquid at the point of counterparty default, and there are deep

[269] The final rule defines the following as a "major currency": United States Dollar (USD); Canadian Dollar (CAD); Euro (EUR); United Kingdom Pound (GBP); Japanese Yen (JPY); Swiss Franc (CHF); New Zealand Dollar (NZD); Australian Dollar (AUD); Swedish Kronor (SEK); Danish Kroner (DKK); Norwegian Krone (NOK); and any other currency as determined by a Prudential Regulator or the Commission.

and liquid markets in the major currencies that allow conversion or hedging to the currency of settlement or termination at relatively low cost. The Commission is including in the final rule the cross-currency haircut for all eligible noncash variation and initial margin collateral, in consideration of the limitations on market liquidity that can frequently arise on those assets in periods of market stress.

In response to commenters' request for clarification, the Commission has revised the final rule text for the cross-currency haircut to refer to the "currency of settlement," and have eliminated the corresponding formulation offered for comment in the proposal.[270] Commenters requested that the Commission provide guidance about the rule's application to current market practice incorporating contractual provisions specifying an agreed-upon currency of settlement, transport currencies and transit, and termination currencies.[271]

In identifying the "currency of settlement" for purposes of this final rule, the Commission will look to the contractual and operational practice of the parties in liquidating their periodic settlement obligations for an uncleared swap in the ordinary course, absent a default by either party. To provide greater clarity, the Commission has added a new definition of "currency of settlement" to the rule. The Commission has defined "currency of settlement" to mean a currency in which a party has agreed to discharge payment obligations related to an uncleared swap or a group of uncleared swaps subject to a master agreement at the regularly occurring dates on which such payments are due in the ordinary course.

[270] The 2014 proposal was formulated as "the currency in which payment obligations under the swap are required to be settled." Proposed Rule, §23.156(a)(1)(iii).
[271] The guidance the Commission is providing about currencies of settlement is specific to the application of this final rule on margin collecting and posting requirements for uncleared swaps.

For eligible non-cash initial margin collateral, the final rule expressly carves out of the cross-currency haircut assets denominated in a single termination currency designated as payable to the non-posting counterparty as part of the eligible master netting agreement. The final rule accommodates agreements under which each party has a different termination currency. If the non-posting counterparty has the option to select among more than one termination currency as part of the agreed-upon termination and close-out process, the agreement does not meet the final rule's single termination currency condition. However, the single termination currency condition does not rule out an eligible master netting agreement establishing more than one discrete netting set and establishing separate margining and early termination provisions for such a select netting set with its own single termination currency.[272]

As an alternative to the 8 percent cross-currency haircut, commenters urged the Commission to permit any cross-currency sensitivity between the swap portfolio credit exposure and the margin collateral provided against that exposure to be measured as a component of the margin required to be exchanged under the rule. The Commission is concerned this alternative presupposes the CSE's certain knowledge, at the time margin amounts must be determined, of the collateral denomination to be posted by the counterparty in response to the margin call and the denomination of future settlement payments. The likelihood of such information being predictably available to the CSE does not square with commenters' depiction of the amount of optionality exercised with respect to these factors by swap market participants in current market practice.

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[272] As discussed above, the final rule permits discrete netting sets under a single eligible master netting agreement, subject to conditions specified in §§ 23.152(c) and 23.153(c).

The 8 percent foreign currency haircut – to the extent it arises in application of the final rule – is additive to the final rule's standardized prudential supervisory haircuts that vary by asset class. These haircuts are unchanged from the proposal. They have been calibrated to be broadly consistent with valuation changes observed during periods of financial stress, as noted above.

Although commenters suggested that the Commission permit CSEs to determine haircuts through the firm's internal models, the Commission believes the simpler and more transparent approach of the standardized haircuts is adequate to establish appropriately conservative discounts on eligible collateral. The final rule permits initial margin calculations to be performed using an initial margin model in recognition of the fact that swaps and swap portfolios are characterized by a number of complex and inter-related risks that depend on the specifics of the swap and swap portfolio composition and are difficult to quantify in a simple, transparent and cost-effective manner. The exercise of establishing appropriate haircuts based on asset class of eligible collateral across long exposure periods is much simpler as the risk associated with a position in any particular margin eligible asset can be reasonably and transparently determined with readily available data and risk measurement methods that are widely accepted.

Finally, because the value of collateral may change, a CSE must monitor the value and quality of collateral previously collected or posted to satisfy minimum initial margin requirements. If the value of such collateral has decreased, or if the quality of the collateral has deteriorated so that it no longer qualifies as eligible collateral, the CSE must collect or post additional collateral of sufficient value and quality to ensure that all applicable minimum margin requirements remain satisfied on a daily basis.

4. Other Collateral

Consistent with the proposal, § 23.156(a)(5) of the final rule states that CSE may collect or post initial margin that is not required pursuant to the rule in any form of collateral.

The Dodd-Frank Act provides that in prescribing margin requirements, the Commission shall permit the use of noncash collateral, as the Commission determines to be consistent with (1) preserving the financial integrity of markets trading swaps; and (2) preserving the stability of the United States financial system. The Commission believes that the eligibility of certain non-cash collateral, subject to the conditions and restrictions contained in the final rule, is consistent with the Dodd-Frank Act, because the use of such non-cash collateral is consistent with preserving the financial integrity of markets by trading swaps and preserving the stability of the United States financial system. The non-cash collateral permitted is highly liquid and resilient in times of stress and the rule does not permit collateral exhibiting other significant risk. The use of different types of eligible collateral pursuant to the requirements of the final rule should also incrementally increase liquidity in the financial system.

H. Custodial Arrangements

1. Proposal

Under the proposal, each CSE that posts initial margin with respect to an uncleared swap would be mandated to require that all funds or other property that it provided as initial margin be held by one or more custodians that are not the CSE or the counterparty or are not affiliates of the CSE or the counterparty. Each CSE that collects initial margin with respect to an uncleared swap would be mandated to require that required initial margin be held at one or more custodians that are not the CSE or the counterparty or are not affiliates of the CSE or the counterparty.

Each CSE would be required to enter into custodial agreements containing specified terms. These would include a prohibition on rehypothecating the margin assets and standards for the substitution of assets.

The Commission previously adopted rules implementing section 4s(l) of the Act.[273] The Commission proposed to amend those rules to reflect the approach set out in the proposal where segregation of initial margin would be mandatory under certain circumstances.

2. Comments

The Commission received several comments regarding custody of margin collateral.

Several commenters that operate as custodian banks requested clarification whether the final rule's prohibition against the custodian rehypothecating, repledging, reusing or otherwise transferring initial margin funds or property means that a custodian bank is not permitted to accept cash funds that it holds pursuant to §23.157 as a general deposit, and use such funds as it would any other funds placed on deposit with it.[274]

Under § 23.156, eligible collateral for initial margin includes "immediately available cash funds" that are denominated in a major currency or the currency of settlement for the uncleared swap. It is not practical for cash funds to be held by a custodian as currency that remains the property of the posting party with a security

[273] Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy, 78 FR 66621 (Nov. 6, 2013).
[274] State Street; SIFMA; ABA, Sifma-AMG.

interest being granted to its counterparty, e.g., by placing such currency in a safety deposit box or in the custodian's vault. Rather, the custodian banks explained in their joint comment letter that, under their current business practices, when a customer provides them with cash funds to hold as a custodian, the custodian bank accepts the funds as a general deposit, with the cash becoming property of the custodian bank and the customer holding a contractual debt obligation, i.e., a general deposit account, of the custodian bank.[275]

When holding cash under the arrangement described by the custodian bank commenters, a custodian is not a custodian of a discrete asset but rather a recipient of cash under a contractual arrangement that establishes a debt obligation to be paid on demand, i.e., the custodian is acting as a bank. When such a customer has pledged cash funds as collateral under the arrangements described by the commenters, the commenter's property interest is the deposit account liability that the custodian bank owes to the customer.

Several commenters supported the requirement that initial margin be held at a third party custodian that was not affiliated with either the CSE or its counterparty.[276] Other commenters contended that the independent third-party custodian requirement is unnecessary and the Commission should allow for more flexibility in how initial margin is kept, including permitting the counterparties to negotiate acceptable custodians, including affiliated custodians.[277] These commenters expressed concern about complexities that additional parties bring to the relationship, as well as reservations about

[275] State Street.
[276] See State Street; ICI (in addition to urging the Commission to require mandatory segregation for excess margin amounts); AFR; and Public Citizen.
[277] See ISDA; Sifma; GPC; Sifma-AMG; ABA; JBA; MFA; JFMC.

the capacity and availability of established custodians in the marketplace. One commenter argued against independent third-party custodians, citing increased costs arising from the negotiation of custodial contracts and the cost of developing operational infrastructure, as it is not the current practice for certain financial entities.[278]

Commenters also expressed concerns with meeting the proposal's requirement that the custodial agreement be legal, valid, binding, and enforceable under the laws of all relevant jurisdictions, including asking the Commission to specify that the only relevant jurisdiction is that of the custodian.[279] The same commenters urged more flexibility in custodial agreements to be consistent with current market practice. Another commenter noted that custodians should not be excluded solely because they are affiliates of either the CSE or the counterparty since the number of custodians is limited and many of the largest custodians are affiliates of CSEs.[280] The same commenter also argued that CSEs should not be required to segregate initial margin that is not subject to mandatory posting or collection.

Several commenters recommended lifting the restriction on rehypothecation and reuse of initial margin collateral, either generally or on a conditional basis.[281] One commenter recommended that the final rule allow limited rehypothecation that would meet the requirements of the 2013 international framework if a model for such rehypothecation could be developed for use by counterparties. The commenter also noted that other regulators may permit rehypothecation and, if so, a prohibition would

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[278] See GPC.
[279] See BP; Shell; TRM; GPC; ISDA (asking for clarification of the enforceability requirements, including whether the enforceability in bankruptcy provisions refer to the bankruptcy of the CSE or the counterparty); Sifma-AMG (contending that the Commission instead adopt disclosure instead of enforceability requirements)..
[280] See ISDA.
[281] See CPFM; CCMR; IFM; ISDA; Sifma; ABA; CS; and FSR.

create a competitive disadvantage for market participants subject to the Commission's rule. Other commenters supported the restriction on rehypothecation and reuse.[282] Two commenters argued that the prohibition on rehypothecation and reuse of initial margin should not restrict the custodian's ability to accept cash collateral, as cash collateral would be reinvested in the custodian's account.[283]

Several commenters requested that the final rule allow greater flexibility in segregation arrangements. These commenters requested that the final rule permit arrangements such as title transfer and charge-back of margin, segregation of margin on the books of the CSE or within an affiliate if such collateral is insulated from the CSE's insolvency.

One commenter requested that the final rule clarify that the required custodian arrangements be tri-party, i.e., entered into pursuant to an agreement between the CSE , its counterparty, and the custodian.[284] The commenter wrote that if a CSE's counterparty is not a party to the custodial agreement, it would not be in contractual privity with the unaffiliated custodian, and the CSE essentially would exercise exclusive control over its counterparty' initial margin.

3. Discussion

(a) Initial margin

The final rule establishes minimum standards for the safekeeping of collateral. Section 23.157(a) addresses requirements for when a CSE posts any collateral other than variation margin. Posting collateral to a counterparty exposes a CSE to risks in

[282] See ICI; Sifma-AMG; GPC; PublicCitizen; and AFR.
[283] See Sifma-AMG and MetLife.
[284] MFA.

recovering such collateral in the event of its counterparty's insolvency.  To address these risk and to protect the safety and soundness of the CSE, § 23.157(a) requires a CSE that posts any collateral required under the final rule other than variation margin with respect to a uncleared swap to require that such collateral be held by one or more custodians that are neither the CSE, its counterparty, or an affiliates of either counterparty.  This requirement applies to initial margin posted by a CSE pursuant to § 23.152.

Section 23.157(b) addresses requirements for when a CSE collects initial margin required by § 23.152.  Under § 23.157(b), the CSE shall require that initial margin collateral collected pursuant to § 23.152 be held at one or more custodians that are neither the CSE, its counterparty, or an affiliate of either counterparty.  As is the case with initial margin that a CSE posts, the § 23.157(b) applies only to initial margin that a CSE collects as required by § 23.154, rather than all collateral collected.

For collateral subject to § 23.157(a) or § 23.157(b), § 23.157(c) requires the custodian to act pursuant to a custodial agreement that is legal, valid, binding, and enforceable under the laws of all relevant jurisdictions, including in the event of bankruptcy, insolvency, or similar proceedings.  Such a custodial agreement must prohibit the custodian from rehypothecating, repledging, reusing or otherwise transferring (through securities lending, repurchase agreement, reverse repurchase agreement, or other means) the funds or other property held by the custodian.   Cash collateral may be held in a general deposit account with the custodian if the funds in the account are used to purchase other forms of eligible collateral, such eligible noncash collateral is segregated pursuant to § 23.157, and such purchase takes place within a time period reasonably necessary to consummate such purchase after the cash collateral is posted as initial margin.[285]

In response to the comments, the Commission notes that the ultimate purpose of the custody agreement is twofold: (1) that the initial margin be available to a counterparty when its counterparty defaults and a loss is realized that exceeds the amount of variation margin that has been collected as of the time of default; and (2) initial margin be returned to the posting party after its swap obligations have been fully discharged.

The jurisdiction of the custodian is certainly one of the relevant jurisdictions. Thus, a CSE must conduct sufficient legal review to conclude with a well-founded basis and maintain sufficient written documentation of that legal review that in the event of a legal challenge, including one resulting from default or from receivership, conservatorship, insolvency, liquidation, or similar proceedings of the custodian, the relevant court or administrative authorities would find the custodial agreement to be legal, valid, binding, and enforceable under the law applicable to the custodian. A CSE would also be expected to establish and maintain written procedures to monitor possible changes in relevant law and to ensure that the agreement continues to be legal, valid, binding, and enforceable under that law.

The jurisdiction of a CSE's counterparty, however, is also a relevant jurisdiction. The CSE would have to ensure that if a counterparty were to become insolvent, or otherwise be placed under the control of a resolution authority, that there would not be a legal basis to set aside the custodial arrangement, allowing the resolution authority to reclaim for the estate assets that the counterparty had placed with the custodian. Thus,

[285] As described earlier, collateral other than certain forms of cash is subject to a haircut. As a result, when cash collateral is used to purchase other forms of eligible collateral, a haircut will need to be applied.

the CSE would have to conduct a sufficient legal review to conclude with a well-founded basis that in the event of a legal challenge, including one resulting from default or from receivership, conservatorship, insolvency, liquidation, or similar proceedings of the counterparty, the relevant court or administrative authorities would find the custodial agreement to be legal, valid, binding, and enforceable by the CSE under the law applicable to the counterparty. For this reason, the Commission declines to follow the commenters' request that the Commission clarify that the only relevant jurisdiction is that of the custodian.

Under § 23.156, eligible collateral for initial margin includes "immediately available cash funds" that are denominated in a major currency or the currency of settlement for the uncleared swap. However, permitting initial margin collateral to be held in the form of a deposit liability of the custodian bank is inconsistent with the final rule's prohibition against rehypothecation of such collateral. In addition, employing a deposit liability of the custodian bank – or another depository institution – is inconsistent with the final rule's prohibition against use of obligations issued by a financial firm.

On the other hand, as a practical matter, it is very difficult to eliminate cash entirely. For example, the final rule's T+1 margin collection requirement means that it will often be necessary to use cash to cover the first days of a margin call. In addition, income generated by non-cash assets in custody will be paid in cash. Collateral reinvestments involving replacement of one category of non-cash asset with another category of non-cash asset may create cash balances between settlements. While the parties all have strong business incentives to manage and limit these cash fund balances, eliminating them entirely would result in a number of inefficiencies.

To address these concerns, the Commission has revised the final rule to allow cash funds that are placed with a custodian bank in return for a general deposit obligation to serve as eligible initial margin collateral only in specified circumstances. However, the rule requires the posting party to direct the custodian to reinvest the deposited funds into eligible non-cash collateral of some type, or the posting party to deliver eligible non-cash collateral to substitute for the deposited funds. As noted above, the appropriate haircut must be applied. This reinvestment must occur within a reasonable period of time after the initial placement of cash collateral to satisfy the initial margin requirement, and the amount of eligible collateral must be sufficient to cover the initial margin amount in light of the applicable haircut on the non-cash collateral pursuant to the final rule.

CSEs must appropriately oversee their own initial margin collateral posting and that of their counterparties in order to constrain the use of cash funds, and achieve efficient reinvestment of cash funds in excess of operational and liquidity needs into eligible margin securities. In connection with implementing the final rule, CSEs should ensure these procedures are adequate to assess the levels of cash necessary under the circumstances of each counterparty relationship, and to ensure the custodian will be directed to reinvest the remainder in non-cash collateral promptly, or that the posting party will substitute non-cash assets promptly, as applicable.

Section 23.157(c)(2) provides that, notwithstanding this prohibition on rehypothecating, repledging, reusing or otherwise transferring the funds or property held by the custodian, the posting party may substitute or direct any reinvestment of collateral, including, under certain conditions, collateral collected pursuant to § 23.152(a) or posted pursuant to § 23.152(b).

In particular, for initial margin collected pursuant to § 23.152(a) or posted pursuant to § 23.152(b), the posting party may substitute only funds or other property that meet the requirements for eligible collateral under § 23.156 and where the amount net of applicable haircuts described in § 23.156 would be sufficient to meet the initial margin requirements of § 23.152. The posting party also may direct the custodian to reinvest funds only in assets that would qualify as eligible collateral under § 23.156 and ensure that the amount net of applicable haircuts described in § 23.156 would be sufficient to meet the initial margin requirements of § 23.152. In the cases of both substitution and reinvestment, the final rule requires the CSE to ensure that the value of eligible collateral net of haircuts that is collected or posted remains equal to or above the minimum requirements.

In the cases of both substitution and reinvestment, the final rule requires the posting party to ensure that the value of eligible collateral net of haircuts remains equal to or above the minimum requirements contained in § 23.152. In addition, the restrictions on the substitution of collateral described above do not apply to cases where a CSE has posted or collected more initial margin than is required under § 23.152. In such cases, the initial margin that has been posted or collected in satisfaction of § 23.152 is subject to the restrictions on collateral substitution but any additional collateral that has been posted or collected is not subject to the restrictions on collateral substitution and, as noted above, is not subject to any of the requirements of § 23.157.

The Commission is adopting the segregation requirement in this rule to help ensure the safety and soundness of CSEs subject to the rule and to offset the greater risk to the financial system arising from the use of uncleared swaps. The Commission has retained the requirement that the custodian be unaffiliated with either the CSE or its counterparty. In adopting this requirement, the Commission is more concerned that customer confidence in a particular CSE could be correlated with customer confidence in the affiliated custodian, especially in times of high market stress, whereas the use of independent custodians should offer counterparties a greater measure of confidence. Thus, the Commission believes that it is necessary for the safety and soundness of CSE and to minimize risk to the financial system that collateral be held by a custodian that is neither a counterparty to the swap nor an affiliate of either counterparty. This arrangement protects both counterparties from the risk of the initial margin being held as part of one counterparty's estate (or its affiliate's estate) in the event of failure, and therefore not available to the other counterparty.

The Commission does not believe that the alternative arrangements suggested by the commenters (e.g., arrangements involving title transfer and charge back of margin) adequately ensure the safety and soundness of the CSE nor adequately offset the risk to the financial system arising from the use of uncleared swaps. In addition, the Commission believes the specific structure of the custody arrangements required by the rule are better left, on balance, to negotiations of the parties, in accordance with the specific concerns of those parties. Tri-party custody may be an optimal arrangement for some firms, while for others, it has not typically been sought under established market practice.

Further, the Commission is declining to revise the proposed regulation to accommodate rehypothecation pursuant to some future model that may be developed. Commenters who argued for allowing limited rehypothecation did not propose a specific model, and hence the Commission is not inclined to permit rehypothecation at this time due to hypothetical scenarios that may or may not develop in the future.

(b) Variation margin.

Section 23.157 does not require collateral that is collected or posted as variation margin to be held by a third party custodian or subject such collateral to restrictions on rehypothecation, repledging, or reuse. So, subject to negotiations between the counterparties, a CSE that is a depository institution could collect cash posted to it in satisfaction of section 23.153 from a counterparty without establishing a separate account for the counterparty. The cash funds would be the property of the CSE, which would be permitted to reuse such funds without restriction. Similarly, a CSE's counterparty would not be required to segregate cash funds posted as variation margin by the CSE. The same is true with respect to eligible non-cash collateral exchanged as variation margin with a financial end user pursuant to §23.156; the segregation and custody requirements of §23.157 do not apply.

Section 23.156(b) of the final rule permits eligible non-cash collateral to be posted as variation margin for swaps between a CSE and a financial end user. In such circumstances, a CSE or its financial end user counterparty could reach an agreement under which either party could itself hold non-cash collateral posted by the other and such non-cash collateral could be rehypothecated, repledged, or reused.

The final rules in this area are consistent with those of the Prudential Regulators.

I. Documentation

1. Proposal

The proposal sets forth documentation requirements for CSEs.[286] For uncleared swaps between a CSE and a counterparty that is a swap entity or a financial end user, the documentation would be required to provide the CSE with the contractual right and obligation to exchange initial margin and variation margin in such amounts, in such form, and under such circumstances as are required by § 23.150 through § 23.161 of this part. For uncleared swaps between a CSE and a non-financial end user, the documentation would be required to specify whether initial and/or variation margin will be exchanged and, if so, to include the information set forth in the rule. That information would include the methodology and data sources to be used to value positions and to calculate initial margin and variation margin, dispute resolution procedures, and any margin thresholds.

The Commission proposal contains a cross-reference to an existing Commission rule which already imposes documentation requirements on SDs and MSPs.[287] Consistent with that rule, the proposal would apply documentation requirements not only to covered counterparties but also to non-financial end users. Having comprehensive documentation in advance concerning these matters would allow each party to a swap to manage its risks more effectively throughout the life of the swap and to avoid disputes regarding issues such as valuation during times of financial turmoil. This would benefit not only the CSE but the non-financial end user as well.

2. Comments

[286] Proposed § 23.158.
[287] Commission Regulation 23.504.

The Commission received several comments regarding documentation. Commenters sought clarification over aspects of the documentation requirement.[288] One commenter contended that the documentation standards are too burdensome since initial margin methodologies may be proprietary and complex while the other Commission regulations already address documentation standards for valuations.[289] Another commenter argued that it would be difficult to comply with the documentation standards with respect to valuations, and noting that valuation standards are already addressed in other Commission regulations.[290] Commenters remarked that non-financial end users should not be subject to the documentation requirement.[291]

3. Discussion

The Commission is adopting the documentation requirements substantially as proposed, with one exception for non-financial end users. The Commission has removed the documentation requirements with respect to non-financial end users. To the extent that other aspects of the Commission's regulations address similar requirements, the Commission believes that counterparties should be well-positioned to comply with the documentation requirements and should reduce any additional burdens in implementing this requirement.

[288] See Sifma (the Commission should clarify the dispute resolution and documentation provisions to indicate that (i) the a CSE would not violate its obligations if it releases margin collateral to a counterparty at the conclusion of a dispute mechanism consistent with the U.S. implementation of Basel; and (ii) the parties would not be required to lock in dispute valuation methods); JBA (seeking clarification on the level of documentation and recommending that the documentation required take into account the composition and size of derivative portfolios); ACLI (documentation requirements should be clarified and harmonized with the requirements from the Prudential Regulators and the SEC); and FHLB (the final rule should require CSEs to have documentation that provides for resolution of disputes regarding the calculation of variation and initial margin and the value of collateral collected or posted).
[289] See ISDA.
[290] See Freddie.
[291] See CDEU (non-financial end users are already subject to documentation requirements in other Commission regulations); and COPE (noting that it is market practice for non-financial end users to use ISDAs); BP; Joint Associations.

Under the final rule, the documentation must grant the CSE the contractual right to collect and to impose the obligation to post initial and variation margin in such amounts, in such form, and under such circumstances as are required by the rule. The documentation must also specify the methods, procedures, rules, and inputs for determining the value of each uncleared swap and the procedures by which any disputes concerning the valuation of uncleared swaps may be resolved. Finally, the documentation must also describe the methods, procedures, rules, and inputs used to calculate initial and variation margin for uncleared swaps entered into between the CSE and the counterparty.

J. Inter-Affiliate Trades

1. Proposal

The proposal effectively would have required two-way initial margin and variation margin for swaps between CSEs and affiliates that were swap entities or financial end users. The Prudential Regulators' proposal set forth the same requirements.

2. Comments

Many commenters urged the Commission to exclude swaps between affiliates from margin requirements.[292] Commenters generally argued that inter-affiliate swaps are already centrally risk managed and requiring margin on inter-affiliate trades could discourage effective risk management[293] and the current practice of exchanging variation

[292] See ISDA, JFMC; Sifma, ABA, JBA, CS, Shell TRM (if inter-affiliate transactions are subject to margin requirements, the Commission should define the term "affiliate" consistently with other Commission regulations); BP; and FSR. Sifma suggested excluding inter-affiliate swaps from margin requirements if the swaps are subject to a group-wide consolidated risk management program and the exchange of variation margin, and the CSE is part of a group that is subject to consolidated capital requirements consistent with Basel. JBA argued that the risks posed by inter-affiliate trades are generally lower and pointed out the difficulties associated with entering into a CSA with all covered counterparties within a limited timeframe.
[293] See Sifma, JBA, ABA, TCH, and CS.

margin should be sufficient to mitigate the risk posed by inter-affiliate trades.[294] They argued that requiring margin generally, and initial margin in particular, on inter-affiliate swaps was unnecessary for systemic stability. They further argued that imposing margin requirements on inter-affiliate swaps would impose significant costs,[295] tie up liquidity,[296] be inconsistent with the approach taken in a number of other jurisdictions,[297] and introduce group-wide third-party credit risk.[298] Sifma also argued that inter-affiliate swaps should not count towards the margin thresholds and a covered swap entity's material swaps exposure. Another commenter suggested that the Commission conduct a study prior to imposing margin on inter-affiliate trades.[299]

Commenters also suggested alternatives to a full two-way collect-and-post regime for initial margin for affiliate swaps. For example, some commenters proposed that instead of each CSE posting and collecting segregated initial margin to and from its affiliate, the CSE would only collect from its affiliate (subject to a wholly owned subsidiary exemption and a de minimis exemption) and the CSE would be permitted to segregate the initial margin within its group, so as to prevent undue third-party custodial risk.[300] Some suggested a CSE would only collect from an affiliate that is not subject to margin and capital requirements.[301] These commenters further argued that certain highly regulated affiliates like U.S. bank holding companies should benefit from an exception to

[294] See ISDA, Sifma, and CS.
[295] See ISDA, Sifma, ABA, and TCH.
[296] See ISDA, ABA, TCH, and CS.
[297] See ISDA.
[298] See ISDA, ABA, TCH, and CS.
[299] See FSR.
[300] See The Clearing House.
[301] Id.

initial margin requirements.[302] Some commenters also suggested an alternative where the Commission would permit the common parent of an affiliate pair to post a single amount of segregated initial margin in which each affiliate would have a security interest.[303]

3. Discussion

The Commission has determined a CSE shall not be required to collect initial margin from a margin affiliate provided that the CSE meets the following conditions: (i) the swaps are subject to a centralized risk management program that is reasonably designed to monitor and to manage the risks associated with the inter-affiliate swaps; and (ii) the CSE exchanges variation margin with the margin affiliate. These two conditions are consistent with recommendations from commenters. They are conditions that were previously established by the Commission when providing an exemption from the clearing requirement for certain inter-affiliate swaps.[304].

The Commission has determined, however, to require CSEs to collect initial margin from non-U.S. affiliates that are financial end users that are not subject to comparable initial margin collection requirements on their own outward-facing swaps with financial end users. For many of the reasons listed by the commenters, as well as in light of the treatment of inter-affiliate swaps by the prudential regulators, the Commission has determined not to otherwise require CSEs to collect initial margin from, or to post initial margin to, affiliates that are CSEs or financial end users. (As discussed below, pursuant to the Prudential Regulators' rules, CSEs would be required to post initial margin to affiliates that are swap entities subject to those rules.)

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[302] See ISDA.
[303] See The Clearing House.
[304] See § 50.52.

The Commission first notes that the Prudential Regulators decided not to impose a general two-way initial margin requirement. Instead, the Prudential Regulators have required swap entities subject to their rules to collect initial margin from affiliates that are swap entities or financial end users.[305] Thus, if a CSE enters into a swap with a swap entity subject to the Prudential Regulators' rules, the CSE will post initial margin but will not collect initial margin for the transaction.

The Commission considered the comments that inter-affiliate swaps do not increase the overall risk profile or leverage of the group. The Commission further considered the fact that inter-affiliate two-way margin would substantially increase the overall amount of margin being collected, and thus the cost of swap transactions generally, without a commensurate benefit to risk reduction to the overall group. The Commission notes that considering the risk exposure of the overall group of which a CSE is a part is consistent with the approach taken in its margin rules (and the Prudential Regulators' rules) in other key areas —as in the calculation of material swaps exposure to determine overall swaps exposure and the calculation of the initial margin threshold amount to determine whether there is an obligation to collect or post initial margin.

Second, the Commission notes that the treatment of inter-affiliate transactions is related to what the Commission did when it adopted an exemption to the clearing mandate for inter-affiliate transactions in 2013. In that rulemaking, it considered, but decided against, requiring the exchange of initial margin or variation margin as a condition to using the exemption. It stated that such requirements "would limit the ability of U.S. companies to efficiently allocate risk among affiliates and manage risk centrally."[306]

Third, the Commission considered the decision of the Prudential Regulators' not to impose two-way initial margin and impose a collect only obligation instead. If the Commission were to impose two-way margin, it would be inconsistent with the Prudential Regulators' rule. The Commission further considered whether to impose a collect-only obligation. However, this would result in a two-way requirement in transactions between a swap dealer subject to the Prudential Regulators' rules and a CSE, a result which the Prudential Regulators determined not to impose. In addition, the Commission considered the difference in mission and overall regulatory framework between the Prudential Regulators and the Commission. For example, the Commission notes that the imposition of a collect only initial margin requirement on swap entities subject to the Prudential Regulators' rules is similar to existing requirements of law, in that banks are subject to significant regulatory restrictions and requirements on inter-affiliate transactions under Sections 23A and 23B of the Federal Reserve Act. The same cannot be said of a collect-only requirement imposed on CSEs, since the restrictions under Sections 23A and 23B do not apply to nonbank affiliates such as CSEs.

For purposes of symmetry, however, the Commission has determined to require a CSE that enters into an inter-affiliate swap with a swap entity that is subject to the rules of the Prudential Regulators to post initial margin with that swap entity in an amount

[306] Clearing Exemption for Swaps between Certain Affiliated Entities, 78 FR 21750 at 21760 (April 11, 2013).

equal to the amount that the swap entity is required to collect under the rules of the Prudential Regulators. This provision imposes no additional burden on the CSE because the other swap entity would be required to collect the initial margin in any case. This provision simply means that a CSE will be required under CFTC rules to post initial margin to the extent that the other swap entity is required under Prudential Regulator rules to collect it.

The Commission also considered its objective of harmonizing its margin rules as much as possible with international standards. The BCBS standards, for example, state that the exchange of initial and variation margin by affiliated parties "is not customary" and that initial margin in particular "would likely create additional liquidity demands".[307] The Commission recognized that requiring the posting and collection of initial margin for inter-affiliate swaps would be likely to put CSEs at a competitive disadvantage to firms in other jurisdictions. The Commission understands that many authorities, such as those in Europe and Japan, are not expected to require initial margin for inter-affiliate swaps. These savings could enable such firms to offer swaps to third parties on better terms than firms that incur the costs of inter-affiliate initial margin.

The Commission has determined, however, to require CSEs to exchange variation margin with affiliates that are swap entities or financial end users, as is also required under the Prudential Regulators' rules. Marking open positions to market each day and requiring the posting or collection of variation margin will reduce the risks of inter-affiliate swaps.

[307] BCBS IOSCO Report at 21.

As noted above, CSEs will be required to collect initial margin from non-U.S. affiliates that are not subject to comparable initial margin collection requirements on their own outward-facing swaps with financial entities. These affiliates generally would include entities located in jurisdictions for which substituted compliance has not been granted with regard to the collection of initial margin. This requirement would also apply in the case of a series of transactions involving, directly or indirectly, an affiliate that is not subject to comparable initial margin collection requirements. That is, even if the CSE is only in privity of contract with an affiliate who is subject to such requirements, but that affiliate, directly or indirectly, is transacting with another affiliate who is not subject to such requirements, the CSE would be required to collect initial margin.

This provision is an important anti-evasion measure. It is designed to prevent the potential use of affiliates to avoid collecting initial margin from third parties. For example, suppose that an unregistered non-U.S. affiliate of a CSE enters into a swap with a financial end user and does not collect initial margin. Suppose further that the affiliate then enters into a swap with the CSE. Effectively, the risk of the swap with the third party would have been passed to the CSE without any initial margin. The rule would require this affiliate to post initial margin with the CSE in such cases. The rule would further require that the CSE collect initial margin even if the affiliate routed the trade through one or more other affiliates.

K. Implementation Schedule

1. Proposal

The proposed rules set out an implementation schedule for initial margin ranging from December 1, 2015 to December 1, 2019.[308] This extended schedule was designed to give market participants ample time to develop the systems and procedures necessary to exchange margin and to make arrangements to have sufficient assets available for margin purposes. The requirements would be phased-in in steps from the largest covered parties to the smallest.

Variation margin requirements would be implemented on the scheduled first date.

2. Comments

Commenters generally stated that, to the extent practicable, there should be international harmonization of implementation dates for margin and capital requirements.[309] While one commenter supported the proposed compliance date schedules set out in the 2014 proposal,[310] a number of commenters argued that compliance with the final rule should be delayed for 18 months to 2 years in order to allow for operational changes and the need for additional or revised documentation that will be required for CSEs to comply with the rule.[311]

With respect to phasing-in the implementation of the initial margin requirements, a commenter stated that the phase-in provisions should be revised to apply only to uncleared swaps between CSEs.[312] The commenter further stated that non-CSEs should not be required to comply with the initial margin requirements until December 2019. The Commission also received a comment stating that the implementation of the compliance

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[308] Proposed § 23.160.
[309] See Sifma; ABA; Australian Banks.
[310] See CME.
[311] See JFMC; GPC; JBA; ISDA; Sifma-AMG; JBA; CPFM; and Freddie. ISDA further argues that financial end users that fall below the implementation schedule threshold for each relevant time period should not be subject to initial margin.
[312] See GPC.

date schedule should not coincide with code freezes and that margin requirements for over-the-counter derivatives should be taken into consideration when finalizing this rule.[313] Still another commenter argued for a delay in implementation to allow the use of the latest developments from BCBS regarding margin calculation best practices and the development of a universal model.[314]

Several commenters urged that the compliance date for variation margin requirements be phased in, in a manner similar to the compliance dates for the initial margin requirements.[315] These commenters argued, among other things, that the phase-in of the variation margin requirements would allow CSEs the time to re-document all necessary swap contracts at one time. Commenters stated that variation margin requirements should be phased in based on decreasing notional amount thresholds over a two-year period commencing upon the latter of the publication of the margin rules for over-the-counter derivatives in the U.S., the EU and Japan or the publication of the Commission's comparability determinations with respect to the EU and Japan.[316]

Certain commenters also requested that the Commission extend the meaning of swaps entered into prior to the compliance date to include (1) swaps entered into prior to the applicable compliance date (legacy swaps) that are amended in a non-material manner; (2) novations; and (3) new derivatives that result from portfolio compression of legacy derivatives.[317] These commenters urged that if a general exclusion for novated legacy swaps is not provided, there should be an exclusion for novated swaps between

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[313] See Sifma.
[314] See CS.
[315] See ACLI; MefLife; ICI; Sifma; Sifma-AMG; JFMC; GPC; JBA; ISDA; ABA; Freddie; CDEU; and FHLB.
[316] See Sifma; ABA,
[317] See CS; ISDA.

affiliates resulting from organizational restructuring or regulatory requirements such as the swaps push-out rule.

One commenter urged that, during the phase-in period, only entities whose swap volume currently exceeds the applicable threshold should be subject to the margin requirements.[318] The commenter stated that, if the swap activity of either party to a swap declines below the applicable threshold, that party should cease being subject to the initial margin requirements until such time as it exceeds the applicable threshold. Another commenter asked how the margin requirements would apply in the event of a change in status of the counterparty.[319] One commenter requested that the Commission revise the phase-in schedule so that entities that are not CSEs would be subject to the margin requirements in December 2019.[320]

3. Discussion

(a) Initial margin

Under the proposal, the implementation of both initial and variation margin requirements would have started on December 1, 2015. With respect to initial margin requirements, the requirements would have been phased-in between December 1, 2015 and December 1, 2019. Variation margin requirements for all CSE with respect to covered swaps with any counterparty would have been effective as of December 1, 2015. This proposed set of compliance dates was consistent with those set forth in the 2013 international framework.

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[318] See ISDA.
[319] See ISDA.
[320] See GPC (noting issues with providing confidential position information regarding its uncleared swaps to CSEs).

On March 18, 2015, the BCBS and IOSCO issued a press release announcing that the implementation of the 2013 international framework would be delayed by nine months. This announcement was in response to the fact that to date in March 2015, no jurisdiction had yet finalized rules for margin requirements for non-centrally cleared derivatives. Accordingly, the final rule has been revised to delay the implementation of both initial and variation margin requirements by nine months from the compliance schedule set forth in the proposal. This delay results in a uniform approach with respect to compliance dates across the final rule and the international framework.

The changes to the proposed compliance dates should help address concerns raised by commenters. The Commission agrees that international harmonization of margin and capital requirements are prudent. In light of the concerns raised by the commenters and the delay of the implementation of the 2013 international framework, the Commission has incorporated into the final rule provisions reflecting the implementation schedule for the 2013 international framework that was recently set out by the BCBS and IOSCO.

The final rule adopts a phase-in arrangement for variation margin requirements that is different from the proposal. The Commission believes that a phase-in of variation margin requirements similar to the phase-in of initial margin requirements is not necessary because the collection of daily variation margin is currently an industry best practice and will not require many changes in current swaps business operations for CSE covered swaps entities. However, the Commission has revised the 2014 proposal to include the phase-in of compliance dates for variation margin as set forth above to align with the dates suggested by the BCBS and IOSCO on March 18, 2015.

The Commission further believes that classifying new swap transactions as swaps entered into prior to the compliance date could create significant incentives to engage in amendments and novations for the purpose of evading the margin requirements. Moreover, limiting the extension to "material" amendments or "legitimate" novations is difficult to do within the final rule as the specific motivation for an amendment or novation is generally not observable. Finally, the Commission believes that classifying some new swap transactions and transactions entered into prior to the compliance date would make the process of identifying those swaps to which the rule applies overly complex and non-transparent. Accordingly, the Commission has elected not to extend the meaning of swaps entered into prior to the compliance date in this manner requested by some commenters at this time. The Commission recognizes that questions have arisen about the effect of compression exercises which may have implications in a variety of contexts. The Commission is open to further discussion before implementation about the best way to address these questions.

For purposes of initial margin, as reflected in the table below, the compliance dates range from September 1, 2016, to September 1, 2020, depending on the average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange forwards and foreign exchange swaps ("covered swaps") of the CSE and its counterparty (accounting for their respective affiliates) for March, April and May of that year.[321]

[321] "Foreign exchange forward" and "foreign exchange swap" are defined to mean any foreign exchange forward, as that term is defined in section 1a(24) of the Commodity Exchange Act (7 U.S.C. 1a(24)), and foreign exchange swap, as that term is defined in section 1a(25) of the Commodity Exchange Act (7 U.S.C. 1a(25)).

| Compliance Date | Initial Margin Requirements |
|---|---|
| September 1, 2016 | Initial margin where both the CSE combined with all its affiliates and its counterparty combined with all its affiliates have an average daily aggregate notional amount of covered swaps for March, April and May of 2016 that exceeds $3 trillion. |
| September 1, 2017 | Initial margin where both the CSE combined with all its affiliates and its counterparty combined with all its affiliates have an average daily aggregate notional amount of covered swaps for March, April and May of 2017 that exceeds $2.25 trillion. |
| September 1, 2018 | Initial margin where both the CSE combined with all its affiliates and its counterparty combined with all its affiliates have an average daily aggregate notional amount of covered swaps for March, April and May of 2018 that exceeds $1.5 trillion. |
| September 1, 2019 | Initial margin where both the CSE combined with all its affiliates and its counterparty combined with all its affiliates have an average daily aggregate notional amount of covered swaps for March, April and May of 2019 that that exceeds $0.75 trillion. |
| September 1, 2020 | Initial margin for any other CSE with respect to covered swaps with any other covered counterparty. |

In calculating the amount of covered swaps as set forth in the table above, the final rule provides that a CSE shall count the average daily aggregate notional amount of an uncleared swap, an uncleared security-based swap, a foreign exchange forward or a foreign exchange swap between the entity and an affiliate only one time, and shall not count a swap that is exempt from the Commission's margin requirements under §

23.150(b).[322] These provisions were not included in the proposed rule. The purpose of the first provision in the final rule is to prevent double counting of covered swaps between affiliates, a concern raised by number of commenters, which could artificially increase a CSE's average daily aggregate notional amount. The purpose of the second provision is to ensure that swaps that have been exempted from the margin requirements are fully exempted and do not influence other aspects of the rule such as whether an entity maintains a material swaps exposure.

The Commission expects that CSEs likely will need to make a number of operational and legal changes to their current swaps business operations in order to achieve compliance with the provisions of the final rule relating to the initial margin requirements, including potential changes to internal risk management and other systems, trading documentation, collateral arrangements, and operational technology and infrastructure. In addition, the Commission expects that CSEs that wish to calculate initial margin using an initial margin model will need sufficient time to develop such models and obtain regulatory approval for their use. Accordingly, the compliance dates have been structured to ensure that the largest and most sophisticated CSEs and counterparties that present the greatest potential risk to the financial system comply with the requirements first. These swap market participants should be able to make the required operational and legal changes more rapidly and easily than smaller entities engaging in swaps less frequently and pose less risk to the financial system.

(b) Variation margin

[322] See § 23.150(b) of the final rule.

For purposes of variation margin, the compliance dates are September 1, 2016 and March 1, 2017.  Theses compliance dates also depend on the average daily aggregate notional amount of covered swaps of the CSE combined with its affiliates and its counterparties (combined with that counterparty's affiliates) for March, April and May of that year (the "calculation period").[323] Thus, a given CSE may have multiple compliance dates depending on both the combined average daily aggregate notional amount of covered swaps of the CSE and its affiliates during the calculation period as well as the combined average daily notional amount of covered swaps of its counterparties and that counterparty's affiliates during the calculation period.

| Compliance Date | Variation Margin Requirements |
|---|---|
| September 1, 2016 | Variation margin where both the CSE combined with all its affiliates and its counterparty combined with all its affiliates have an average daily aggregate notional amount of covered swaps for March, April and May of 2016 that exceeds $3 trillion. |
| March 1, 2017 | Variation margin for any other CSE with respect to covered swaps with any other counterparty that is a swap entity or financial end user. |

Calculating the amount of covered swaps set forth in the table above for the purposes of determining variation margin is done in the same manner as calculating the amount of covered swaps for purposes of determining initial margin.[324] A CSE shall

[323] See Regulation 23.161.
[324] As a specific example of the calculation, consider a U.S. based financial end user (together with its affiliates) with a portfolio consisting of two uncleared swaps (e.g., an equity swap, an interest rate swap) and one uncleared security-based credit swap.  Suppose that the notional value of each swap is exactly $1

count the average daily aggregate notional amount of a uncleared swap, an uncleared security-based swap, a foreign exchange forward or a foreign exchange swap between the entity and an affiliate only one time, and shall not count a swap that is exempt from the Commission's margin requirements under § 23.150(b).

(c) <u>Changes in material swaps exposure</u>

Once a CSE and its counterparty must comply with the margin requirements for uncleared swaps based on the compliance dates set forth in § 23.161, the CSE and its counterparty shall remain subject to the margin requirements from that point forward. For example, September 1, 2017 is the relevant compliance date where both the CSE combined with all its affiliates and its counterparty combined with all its affiliates have an average aggregate daily notional amount of covered swaps that exceeds $2.25 trillion. If the notional amount of the swap activity for the CSE or the counterparty drops below that threshold amount of covered swaps in subsequent years, their swaps would nonetheless remain subject to the margin requirements. On September 1, 2020, any CSE that did not have an earlier compliance date becomes subject to the initial margin requirements with respect to uncleared swaps.

The Commission has declined to make a change in the final rule that would allow a counterparty whose swap activity declines below the applicable threshold set forth in § 23.161 to cease being subject to margin requirements. The Commission believes that

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trillion on each business day of March, April and May of 2016. Furthermore, suppose that a foreign exchange forward is added to the entity's portfolio at the end of the day on April 29, 2016, and that its notional value is $1 trillion on every business day of May 2016. On each business day of March and April of 2016, the aggregate notional amount of uncleared swaps, security-based swaps and foreign exchange forwards and swaps is $3 trillion. Beginning on May 1, 2016, the aggregate notional amount of uncleared swaps, security-based swaps and foreign exchange forwards and swaps is $4 trillion. The daily average aggregate notional value for March, April and May 2016 is then (23x$3 trillion +21x$3 trillion + 21x$4 trillion)/(23+21+21)=$3.3 trillion, in which case this entity would have a gross notional exposure that would result in its compliance date beginning on September 1, 2016.

allowing entities coverage status to change over time results in additional complexity with little benefit since all entities will be subject to the rule as of September 1, 2020. Accordingly, allowing an entity's coverage status to fluctuate would only be consequential for a limited period of time.

(d) Changes in counterparty status

The Commission has added § 23.161(c) to the final rule to clarify the applicability of the margin requirements in the event a CSE 's counterparty changes its status (for example, if the counterparty is a financial end user without material swaps exposure and becomes a financial end user without material swaps exposure). Under § 23.161(c), in the event a counterparty changes its status such that an uncleared swap with that counterparty becomes subject to stricter margin requirements, then the CSE shall comply with the stricter margin requirements for any uncleared swap entered into with that counterparty after the counterparty changes its status.

Section 23.161(c) states that in the event a counterparty changes its status such that a uncleared swap with that counterparty becomes subject to less strict margin requirements (such as when a counterparty changes status from a financial end user with material swaps exposure to a financial end user without material swaps exposure), then the CSE may comply with the less strict margin requirements for any swap entered into with that counterparty after the counterparty changes its status as well as for any outstanding uncleared swap entered into after the applicable compliance date and before the counterparty changed its status. As a specific example, if a CSE's counterparty transitioned from a financial end user with material swaps exposure to a financial end user without material swaps exposure, initial margin that had been previously collected could be returned if agreed by both parties since the rule would not require an exchange of initial margin on pre-existing or future uncleared swaps.

(e) Applicable EMNA

A CSE may enter into swaps on or after the final rule's compliance date pursuant to the same master netting agreement that governs existing swaps entered into with a counterparty prior to the compliance date. The final rule permits a CSE to (1) calculate initial margin requirements for swaps under an EMNA with the counterparty on a portfolio basis in certain circumstances, if it does so using an initial margin model; and (2) calculate variation margin requirements under the final rule on an aggregate, net basis under an EMNA with the counterparty. Applying the final rule in such a way would, in some cases, have the effect of applying it retroactively to swaps entered into prior to the compliance date under the EMNA.

The Commission received several comments expressing concern that the proposal might require swaps entered into before the compliance dates to be documented under a different EMNA than swaps entered into after the compliance dates in order for the margin requirements not to apply to the pre-compliance dates swaps. As described further above, the Commission has revised the final rule to allow for the establishment of separate netting sets under a single ENMA to avoid this outcome.

(f) Standards expressed in U,S, dollars

The proposal contained a number of numerical amounts that are expressed in U.S. dollar terms. The amounts include the effective date phase-in thresholds, the initial margin threshold amount, the material swap exposure amount, and the minimum transfer amount. These numerical amounts are expressed in the 2013 international framework in terms of Euros. In the proposal, the Commission translated the Euro amounts from the 2013 international framework using a Euro-U.S. Dollar exchange rate that was broadly consistent with the exchange rate that prevailed at the time of the proposal's publication.

In the proposal, the Commission sought comment on how to deal with fluctuations in exchange rates and how such fluctuations may create inconsistencies in the numerical amounts that are established across differing jurisdictions. One commenter suggested using an average exchange rate calculated over a period of time. Another commenter suggested that the Commission should periodically recalibrate these amounts in response to broad movements in underlying exchange rates.

The Commission believes that persistent and significant fluctuations in exchange rates could result in significant differences across jurisdictions that would complicate cross-border transactions and create competitive inequities. The Commission does not agree, however, that the final rule's numerical amounts should be mechanically linked to either prevailing exchange rates or average exchange rates over a period of time as short term fluctuations in exchange rates would result in high frequency changes that would create significant operational and logistical burdens. Rather, and consistent with the view of one commenter, the Commission expects to consider periodically the numerical amounts expressed in the final rule and their relation to amounts denominated in other currencies in differing jurisdictions. The Commission will then propose adjustments, as appropriate, to these amounts.

In the final rule, the Commission is adjusting the numerical amounts described above in light of significant shifts in the Euro-U.S. Dollar exchange rates since the publication of the proposal. Specifically, the Commission is reducing the value of each numerical quantity expressed in dollars to be consistent with a one for one exchange rate with the Euro. As a specific example, the amount of the initial margin threshold is being changed from $65 million in the proposal to $50 million in the final rule. This change will align the U.S dollar denominated numerical amounts in the final rule with those in the 2013 international framework, will be consistent with amounts that have been proposed in margin rules by the European and Japanese authorities, and will be more consistent with the Euro-U.S. Dollar exchange rate prevailing at the time the final rule is published.

## III. Interim Final Rule

### A. Background

Title VII of the Dodd-Frank Act established a comprehensive new regulatory framework for derivatives, which the Act generally characterizes as "swaps" and "security-based swaps."[325] As part of this new regulatory framework, sections 731 of the Dodd-Frank Act added a new section 4s to the CEA which requires registration with the CFTC of swap dealers and major swap participants.[326] These registrants are collectively referred to in this preamble as "swap entities."

As noted earlier, sections 731 of the Dodd-Frank Act requires the Commission to adopt rules that apply to all swap dealer and major swap participants without a prudential regulator, imposing capital requirements and initial and variation margin requirements on all uncleared swaps. The capital and margin requirements under sections 731 of the

[325] "Swaps" are defined in section 721 of the Dodd-Frank Act to include interest rate swaps, commodity-based swaps, equity swaps and credit default swaps. See 7 U.S.C. 1a(47).
[326] See 7 U.S.C. 6s; 15 U.S.C. 78o-10. Section 731 of the Dodd-Frank Act requires swap dealers and major swap participants to register with the CFTC, which is vested with primary responsibility for the oversight of the swaps market under Title VII of the Dodd-Frank Act.

Dodd-Frank Act apply to uncleared swaps and complement other provisions of the Dodd-Frank Act that require the Commission to make determinations as to whether certain swaps, or a group, category, or class of such transactions, should be required to be cleared.[327] If the CFTC has made such a determination, it is generally unlawful for any person to engage in such a swap unless the transaction is submitted to a derivatives clearing organization, as applicable, for clearing.

The clearing requirements, however, do not apply to an entity that is not a financial entity, is using a swap to hedge or mitigate commercial risk, and notifies the Commission, in a manner set forth by the Commission, how it generally meets its financial obligations.[328] Thus, a particular swap might be subject to the capital and margin requirements of section 731 either because it is not subject to the mandatory clearing requirement, or because one of the parties to the swap is eligible for, and elects to use, an exception or exemption from the mandatory clearing requirement. Such a swap is a "uncleared" swap for purposes of the capital and margin requirements established under sections 731 of the Dodd-Frank Act.

Sections 731 direct the Commission to impose initial and variation margin requirements on all swaps that are not cleared. Under the proposed rule, the Commission distinguished among different types of counterparties on the basis of risk.[329]

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[327] 7 U.S.C. 2(h). The CEA sets out standards that the Commission is required to apply when making determinations about clearing, which generally address whether a swap is sufficiently standardized to be cleared. 7 U.S.C. 2(h)(2)(D). To date, the Commission has determined that certain interest rate swaps and credit default swaps are required to be cleared. 17 CFR 50.4.

[328] See 7 U.S.C. 2(h)(7). Further, the Commission has authority to exempt swaps from the clearing requirement. 7 U.S.C. 6(c)(1).

[329] The final rule takes a similar approach. In implementing this risk-based approach, the final rule distinguishes among four separate types of swap counterparties: (i) counterparties that are themselves swap entities; (ii) counterparties that are financial end users with a material swaps exposure; (iii)

On January 12, 2015, President Obama signed into law TRIPRA. Title III of TRIPRA, the “Business Risk Mitigation and Price Stabilization Act of 2015,” amends statutory provisions added by the Dodd-Frank Act relating to margin requirements for swaps and security-based swaps. Specifically, section 302 of TRIPRA’s Title III amends sections 731 and 764 of the Dodd-Frank Act to provide that the initial and variation margin requirements do not apply to certain transactions of specified counterparties that would qualify for an exemption or exception from clearing, as explained more fully below. Uncleared swaps that are exempt under section 302 of TRIPRA will not be subject to the Commission’s rules implementing margin requirements. In section 303 of TRIPRA, Congress required that the Commission implement the provisions of Title III by promulgating an interim final rule and seeking public comment on the interim final rule.

The Commission is therefore promulgating this interim final rule with a request for comment. As noted above, swaps may be uncleared swaps either because (i) there is an exemption or exception from clearing available; or (ii) the Commission has not determined that such swap is required to be cleared. The exclusions and exemptions from the final margin rule will apply to both categories of uncleared swaps when they involve a counterparty that meets the requirements for an exception or exemption from clearing (e.g., a non-financial end user using swaps to hedge or mitigate commercial risk).

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counterparties that are financial end users without a material swaps exposure, and (iv) other counterparties, including nonfinancial end users, sovereigns, and multilateral development banks.

Clearing requirements pursuant to the CEA began to take effect with respect to certain interest rate and credit default swap indices swaps on March 11, 2013.[330] CSEs have accordingly already established methods and procedures to engage in transactions with counterparties that are eligible for the clearing exceptions or exemptions and for recording and reporting the eligibility of these transactions for the exception or exemptions as required under the statute.[331] The Commission expects these processes will function equally well as a basis for the parallel statutory exemptions from initial and variation margin requirements for uncleared swaps implemented pursuant to this interim final rule.

B. Description of the Interim Final Rule

This interim final rule, which adds a new section 23.150(b) to the final rule, adopts the statutory exemptions and exceptions as required under TRIPRA. TRIPRA provides that the initial and variation margin requirements do not apply to the uncleared swaps of three categories of counterparties. In particular, section 302 of TRIPRA amends section 731 so that initial and variation margin requirements will not apply to a swap in which a counterparty (to a CSE) is:

> (1) A non-financial entity (including small financial institution and a captive finance company) that qualifies for the clearing exception under section 2(h)(7)(A) of the Act;
>
> (2) A cooperative entity that qualifies for an exemption from the clearing requirements issued under section 4(c)(1) of the Act; or
>
> (3) A treasury affiliate acting as agent that satisfies the criteria for an exception from clearing in section 2(h)(7)(D) of the Act.

1. Entities qualifying for a clearing exception

[330] 17 CFR 50.25. See 77 FR 44441 (July 30, 2012)
[331] See, e.g., 17 CFR 50.50(b).

TRIPRA provides that the initial and variation margin requirements of the final rule shall not apply to a uncleared swap in which a counterparty qualifies for an exception under section 2(h)(7)(A) of the CEA.[332] Section 2(h)(7)(A) excepts from clearing swaps where one of the counterparties is not a financial entity, is using the swap to hedge or mitigate commercial risk, and notifies the Commission how it generally meets its financial obligations associated with entering into uncleared swaps. A number of different types of counterparties may qualify for an exception from clearing under section 2(h)(7)(A), including: non-financial end users, small banks, savings associations, Farm Credit System Institutions, and credit unions. In addition, captive finance companies qualify for an exception from clearing under section 2(h)(7)(A).

(a) Non-financial end users

A counterparty that is not a financial entity[333] (sometimes referred to as "commercial end users") that is using swaps to hedge or mitigate commercial risk generally would qualify for an exception from clearing under section 2(h)(7)(A) and thus from the requirements of the final rule for uncleared swaps pursuant to section 23.150(b).

(b). Small banks, savings associations, Farm Credit System Institutions, and credit unions

The definition of "financial entity" in section 2(h)(7)(C)(ii) provides that the Commission shall consider whether to exempt small banks, savings associations, Farm

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[332] See 7 U.S.C. 2(h)(7)(A); 15 U.S.C. 78c-3(g)(1).

[333] See 7 U.S.C. 2(h)(7)(A); 15 U.S.C. 78c-3(g)(1); 17 CFR 50.50. A "financial entity" is defined to mean (i) a swap dealer; (ii) a security-based swap dealer; (iii) a major swap participant; (iv) a major security-based swap participant; (v) a commodity pool; (vi) a private fund as defined in section 202(a) of the Investment Advisers Act of 1940; (vii) an employee benefit plan as defined in sections 3(3) and 3(32) of the Employment Retirement Income Security Act of 1974; (viii) a person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature, as defined in section 4(k) of the Bank Holding Company Act of 1956. See 7 U.S.C. 2(h)(7)(C)(i); 15 U.S.C. 78c-3(g)(3).

Credit System Institutions, and credit unions with total assets of $10 billion or less. Pursuant to this authority, the Commission has exempted small banks, savings associations, Farm Credit System Institutions, and credit unions with total assets of $10 billion or less from the definition of "financial entity," thereby permitting these institutions to avail themselves of the clearing exception when they are using swaps to hedge or mitigate risk.[334] As a result, these small financial institutions that are using uncleared swaps to hedge or mitigate commercial risk would also qualify for an exemption from the initial and variation margin requirements of the final rule pursuant to section 23.150(b).

(c). Captive finance companies

Section 2(h)(7)(C) also provides that the definition of "financial entity" does not include an entity whose primary business is providing financing and uses derivatives for the purposes of hedging underlying commercial risks relating to interest rate and foreign exchange exposures, 90 percent or more of which arise from financing that facilitates the purchase or lease of products, 90 percent or more of which are manufactured by the parent company or another subsidiary of the parent company ("captive finance company").[335] These entities can avail themselves of a clearing exception when they are using swaps to hedge or mitigate commercial risk and thus would be eligible for the exemption in the Commission's margin rules pursuant to section 23.150(b).

2. Certain cooperative entities

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[334] See 7 U.S.C. 2(h)(7)(C)(ii); 17 CFR 50.50; 77 FR 42560 (July 19, 2012); as recodified by 77 FR 74284 (Dec 13,2012).

[335] See 7 U.S.C. 2(h)(7)(C)(iii).

TRIPRA provides that the initial and variation margin requirements shall not apply to an uncleared swap in which a counterparty qualifies for an exemption issued under section 4(c)(1) of the Commodity Exchange Act from the clearing requirements of section 2(h)(1)(A) of the Commodity Exchange Act for cooperative entities as defined in such exemption.[336] The Commission, pursuant to its authority under section 4(c)(1) of the Commodity Exchange Act, adopted a regulation that allows cooperatives that are financial entities to elect an exemption from mandatory clearing of swaps that: (1) they enter into in connection with originating loans for their members; or (2) hedge or mitigate commercial risk related to loans to members or swaps with their members which are not financial entities or are exempt from the definition of financial entity.[337] The swaps of these cooperatives that would qualify for an exemption from clearing also would qualify pursuant to section 23.150(b) for an exemption from the margin requirements of the final rule.

3. Treasury affiliates acting as agent

TRIPRA provides that the initial and variation margin requirements shall not apply to an uncleared swap in which a counterparty satisfies the criteria in section 2(h)(7)(D) of the Commodity Exchange Act. These sections provide that, where a person qualifies for an exception from the clearing requirements, an affiliate of that person (including an affiliate predominantly engaged in providing financing for the purchase of the merchandise or manufactured goods of the person) may qualify for the exception as

[336] See 7 U.S.C. 6(c)(1). The CFTC, pursuant to its authority under section 4(c)(1) of the Commodity Exchange Act, adopted 17 CFR 50.51, which allows cooperative financial entities that meet certain qualifications to elect not to clear certain swaps that are otherwise required to be cleared pursuant to section 2(h)(1)(A) of the Commodity Exchange Act.

[337] See 7 U.S.C. 6(c)(1);17 CFR 50.51.

well, but only if the affiliate is acting on behalf of the person and as an agent and uses the swap to hedge or mitigate the commercial risk of the person or other affiliate of the person that is not a financial entity ("treasury affiliate acting as agent").[338] A treasury affiliate acting as agent that meets the requirements for a clearing exemption would also be eligible for an exemption pursuant to section 23.150(b) from the Commission's final rule.

The Commission requests comments on all aspects of the interim final rule

## IV. Related Matters

### A. Regulatory Flexibility Act

The Regulatory Flexibility Act ("RFA") requires that agencies consider whether the regulations they propose will have a significant economic impact on a substantial number of small entities.[339] The RFA does not require agencies to consider the impact of the final rule, including its indirect economic effects, on small entities that are not subject to the requirements of the final rule.[340] In the Proposal, the Commission certified that the proposed rule would not have a significant economic impact on a substantial number of small entities. Following the publication of the proposal, the Commission received a comment on the potential for costs to be passed on to market participants using swaps, including small entities that are not subject to the margin requirements.[341]

[338] See 7 U.S.C. 2(h)(7)(D); 15 U.S.C. 78c-3(g)(4). This exception does not apply to a person that is a swap dealer, security-based swap dealer, major swap participant, major security-based swap participant, an issuer that would be an investment company as defined in section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a-3) but for section 3(c)(1) or 3(c)(7) of that Act, a commodity pool, or a bank holding company with over $50 billion in consolidated assets.
[339] 5 U.S.C. 601 et seq.
[340] See e.g., In Mid-Tex Electric Cooperative v. FERC, 773 F.2d 327 (D.C. Cir. 1985); United Distribution Cos. v. FERC, 88 F.3d 1105, 1170 (D.C. Cir. 1996); Cement Kiln Recycling Coalition v. EPA, 255 F.3d 855 (D.C. Cir. 2001).
[341] NERA's comment is addressed below.

The final rule implements the new statutory framework of Section 4s(e) of the CEA, added by Section 731 of the Dodd-Frank Act, which requires the Commission to adopt capital and initial and variation margin requirements for CSEs on all uncleared swaps in order to offset the greater risk to the swap entity and the financial system arising from the use of swaps and security-based swaps that are not cleared. The final margin requirements will apply to uncleared swaps between covered swap entities and their financial end user counterparties.[342]

As discussed in the Proposal, the Commission previously established certain definitions of "small entities" to be used in evaluating the impact of its regulations on small entities in accordance with the RFA,[343] and that it has determined that SDs, MSPs and eligible contract participants ("ECPs") are not small entities for purposes of the RFA.[344] Accordingly, CSEs that are subject to the final rule are not small entities for purposes of the RFA.

With respect to certain financial end users[345] that may be impacted by the Proposed Rule, the Commission expects that such entities would be similar to eligible contract participants ("ECPs") and, as such, they would not be small entities.[346] As

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[342] In contrast to the proposal, the final rule does not require a CSE to calculate hypothetical initial and variation margin amounts each day for positions held by non-financial end users that have MSEs to the CSE. This should further reduce the possibility that small entities may be indirectly impacted by the final rule.

[343] 47 FR 18618 (Apr. 30, 1982).

[344] See 77 FR 30596, 30701 (May 23, 2012) (SDs and MSPs); 66 FR 20740, 20743 (April 25, 2001) (ECPs).

[345] The RFA focuses on direct impact to small entities and not on indirect impacts on these businesses, which may be tenuous and difficult to discern. See Mid-Tex Elec. Coop., Inc. v. FERC, 773 F.2d 327, 340 (D.C. Cir. 1985); Am. Trucking Assns. v. EPA, 175 F.3d 1027, 1043 (D.C. Cir. 1985).

[346] As noted in paragraph (1)(xii) of the definition of "financial end user" in section 23.151 of the final rule, a financial end user includes a person that would be a financial entity described in paragraphs (1)(i)–(xi) of

discussed above, the final rule applies on a cross-border basis and therefore, to uncleared swaps between CSEs and foreign financial end users. Even assuming that there are any foreign financial entities that would not be considered ECPs (and thus, would be small entities), the Commission expects that only a small number of foreign financial entities that are not ECPs, if any, would trade in uncleared swaps.

The Commission notes that to the extent that small entities may be impacted, the final rule contains numerous provisions that are intended to mitigate - or have the effect of mitigating - the cost on such entities. For example, under the final rule, the level of the aggregate notional amount of transactions that give rise to material swaps exposure has been raised from $3 billion to $8 billion, which should result in a fewer financial end users being required to post initial margin. In addition, the final rule provides an initial margin threshold of $50 million from all uncleared swaps between a covered swap entity and its counterparties, which should further reduce the impact of the rule on financial counterparties that may be small entities.

For the reasons discussed above, the Commission finds that there will not be a substantial number of small entities impacted by the final rule. Therefore, the Chairman, on behalf of the Commission, hereby certifies pursuant to 5 U.S.C. 605(b) that the final rule will not have a significant economic impact on a substantial number of small entities.

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that definition, if it were organized under the laws of the United States or any State thereof. The Commission believes that this prong of the definition of financial end user would capture the same type of U.S. financial end users that are ECPs, but for them being foreign financial entities. Therefore, for purposes of the Commission's RFA analysis, these foreign financial end users will be considered ECPs and therefore, like ECPs in the U.S., not small entities.

## B. Paperwork Reduction Act

The Paperwork Reduction Act of 1995 ("PRA")[347] imposes certain requirements on Federal agencies, including the Commission, in connection with their conducting or sponsoring any collection of information, as defined by the PRA. This final rule will result in a mandatory collection of information within the meaning of the PRA. The collection is necessary to implement section 4s(e) of the CEA, which directs the Commission to adopt rules governing margin requirements for SDs and MSPs. In accordance with the requirements of the PRA, the Commission may not conduct or sponsor, and a person is not required to respond to, this collections of information unless it displays a currently valid OMB control number.

As described below, all of the collections of information required by the final rule are covered by existing OMB Control Number 3038-0024 and OMB Control Number 3038-0088, with OMB Control Number 3038-0024 requiring a revision of the burden hours. The titles for these collections of information are "Regulations and Forms Pertaining to Financial Integrity of the Market Place, OMB control number 3038-0024" and "Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, OMB control number 3038-0088."[348]

### 1. Clarification of Collection 3038-0088

The final rule contains reporting and recordkeeping requirements that are part of the existing Commission regulations pertaining to swap trading relationship

[347] 44 U.S.C. 3501 et seq.

[348] The Commission notes that certain provisions of Regulation 23.158 are already covered by OMB Control Number 3038-0104, which is not affected by this final rule.

documentation requirements. The collection of information related to that existing Commission regulation is covered by OMB Control Number 3038-0088.[349]

Specifically, under the final rule, both the formula employed in the standardized method and the approach of the risk-based model that reflect offsetting exposures require that offsets be reflected only for swaps that are subject to the same eligible master netting agreement ("EMNA"). Regulation 23.151 defines the term EMNA and provides that a CSE that relies on the agreement for purpose of margin calculation must establish and maintain written procedures for monitoring relevant changes in the law and to ensure that the agreement continues to satisfy the requirements of this section. Regulation 23.153(d) further specifies that a CSE must demonstrate upon request to the satisfaction of the Commission that it has made appropriate efforts to collect or post the required margin. In addition, Regulation 23.154 establishes standards for initial margin models and requires CSEs to describe to the Commission any remedial actions being taken, and report internal audit findings regarding the effectiveness of the initial margin model to the CSE's board of directors or a committee thereof , to adequately documents all material aspects of its initial margin model; and, to adequately documents internal authorization procedures, including escalation procedures that require review and approval of any change to the initial margin calculation under the initial margin model, demonstrable analysis that any basis for any such change is consistent with the requirements of this section, and independent review of such demonstrable analysis and approval. Regulation 23.155(b) requires a covered swap entity to create and maintain documentation setting forth the variation margin methodology, evaluate the reliability of its data sources at least

[349] See OMB Control No. 3038-0088, available at http://www.reginfo.gov/public/do/PRAOMBHistory?ombControlNumber=3038-0088.

annually, and make adjustments, as appropriate. It also provides that the Commission at any time may require a covered swap entity to provide further data or analysis concerning the methodology or a data source. Regulation 23.157(c) requires the custodian to act pursuant to a custody agreement that prohibits the custodian from re-hypothecating, repledging, reusing, or otherwise transferring the funds held by the custodian. Regulation 23.158 requires a covered swap entity to execute trading documentation with each counterparty that is either a swap entity or financial end user regarding credit support arrangements.

The reporting and recordkeeping requirements of Regulations 23.154(b)(4) through 23.154(b)(7), and Regulations 23.155(b), 23.157(c) and 23.158, described above, fall under the Commission Regulations 23.500 through 23.506[350] and are covered by OMB Control Number 3038-0088. Further, the reporting and recordkeeping requirements in Regulation 23.154(b)(4) through 23.154(b)(7) and Regulations 23.155(b), 23.157(c) and 23.158, would not materially impact the burden estimates currently provided for in OMB Control Number 3038-0088.[351]

2. Revisions to Collection 3038-0024

[350] See 77 FR 55904 (Sept. 12, 2012). Commission Regulation 23.504(b) requires an SD or MSP to maintain written swap trading relationship documentation that must include all terms governing the trading relationship between the SD or MSP and its counterparty, and Commission Regulation 23.504(d) requires that each SD and MSP maintain all documents required to be created pursuant to Commission Regulation 23.504. Commission Regulation 23.502(c) requires each SD and MSP to notify the Commission and any applicable Prudential Regulator of any swap valuation dispute in excess of $20 million if not resolved in specified timeframes.

[351] The Commission is publishing a separate notice in the Federal Register to renew OMB Control Number 3038-0088, which will revise the burden estimates relating to the collection titled "Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants."

As noted above, the final will require a new information collection, which is covered by OMB Control Number 3038-0024.[352] However, the final rule will revise the burden hours associated with the collection, as discussed below.

Regulation 23.154(b)(1) requires CSEs that wish to use initial margin models to obtain the Commission's approval, and to demonstrate, on a continuing basis, to the Commission that the models satisfy standards established in Regulation 23.154. These standards include: (i) a requirement that a CSE notify the Commission in writing 60 days before extending the use of the model to additional product types, making certain changes to the initial margin model, or making material changes to modeling assumptions; and (ii) a variety of quantitative requirements, including requirements that the CSE validate and demonstrate the reasonableness of its process for modeling and measuring hedging benefits, demonstrate to the satisfaction of the Commission that the omission of any risk factor from the calculation of its initial margin is appropriate, demonstrate to the satisfaction of the Commission that incorporation of any proxy or approximation used to capture the risks of the covered swap entity's non-cleared swaps is appropriate, periodically review and, as necessary, revise the data used to calibrate the initial margin model to ensure that the data incorporate an appropriate period of significant financial stress.

Currently, there are approximately 106 SDs and MSPs provisionally registered with the Commission. The Commission further estimates that approximately 54 of the

[352] The Commission previously proposed to adopt regulations governing standards and other requirements for initial margin models that would be used by SDs and MSPs to margin uncleared swap transactions. See Capital Requirements of Swap Dealers and Major Swap Participants, 76 FR 27,802 (May 12, 2011). As part of the October 3, 2014 proposal, the Commission submitted proposed revisions to collection 3038-0024 for the estimated burdens associated with the margin model to OMB.

SDs and MSPs will be subject to the Commission's margin rules as they are not subject to a Prudential Regulator. The Commission further estimates that all SDs and MSPs will seek to obtain Commission approval to use models for computing initial margin requirements. The Commission estimates that the information collection requirement associated with this aspect of the final rule will impose an average of 240 burden hours per registrant.

Based upon the above, the estimated additional hour burden for collection 3038-0024 was calculated as follows:

Number of registrants: 54

Frequency of collection: Initial submission and periodic updates.

Estimated annual responses per registrant: 1.

Estimated aggregate number of annual responses: 54.

Estimated annual hour burden per registrant: 240 hours.

Estimated aggregate annual hour burden: 12,960 hours [54 registrants x 240 hours per registrant].

## V. Cost Benefit Considerations

### A. Introduction

Section 15(a) of the CEA requires the Commission to consider the costs and benefits of its discretionary actions before promulgating a regulation under the CEA or issuing certain orders.[353] Section 15(a) further specifies that the costs and benefits shall be evaluated in light of five broad areas of market and public concern: (1) protection of

[353] 7 U.S.C. 19(a).

market participants and the public; (2) efficiency, competitiveness, and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations. In this section, the Commission discusses the costs and benefits resulting from its discretionary determinations with respect to the section 15(a) factors.[354]This rulemaking implements the new statutory framework of Section 4s(e) of the CEA, added by Section 731 of the Dodd-Frank Act, which requires the Commission to adopt capital and initial and variation margin requirements for CSEs. Section 4(s)(e) of the CEA requires the Commission to adopt initial and variation margin requirements for CSEs on all of their uncleared swaps, which should be designed to ensure the CSE's safety and soundness and be appropriate for the risk associated with the uncleared swap. In addition, section 4s(e)(3)(D) of the CEA provides that the Commission, the Prudential Regulators, and the SEC, must "to the maximum extent practicable" establish and maintain comparable margin rules.

The Commission recognizes that there are inherent trade-offs in developing minimum collateral standards for uncleared swaps. Margin rules for uncleared swaps are designed to reduce the probability of default by the CSE and limit the amount of leverage that can be undertaken by CSEs (and other market participants, in the aggregate), which ultimately mitigates the possibility of a systemic event. The financial crisis of 2008 has had profound and long-lasting adverse effects on the economy, and therefore reducing the potential for another systemic event provides significant, if unquantifiable, benefits. At the same time, the final margin rule will entail new costs for CSEs and financial end

[354] The Commission notes that the costs and benefits considered in finalizing the margin rule, and highlighted below, have informed the policy choices described throughout this release.

users as they will need to provide liquid, high-quality collateral to meet those requirements that exceed current practice and as a result, incur costs in terms of lost returns from investments or in securing additional sources of funding (e.g., interest expenses associated with borrowing funds).[355] In addition, CSEs and financial end users will face certain startup and ongoing costs relating to technology and other operational infrastructure, as well as new or updated legal agreements.[356] The final rule reflects the Commission's reasoned judgment of how best to ensure the safety and soundness of CSEs and the U.S. financial system, in a manner that considers the economic consequences of its policy choices.

The Commission also recognizes that many CSEs are part of bank holding companies with global operations that are subject to overlapping jurisdictions by multiple supervisory authorities, both domestic and foreign. Significant disparities in margin rules can lead to undue competitive distortions and ultimately, opportunities for regulatory arbitrage.[357] It could also lead to operational inefficiencies as entities within the same corporate group may be precluded from utilizing congruent operational and compliance infrastructure. In light of these concerns, and in accordance with the statutory mandate, the Commission, in developing the final rule, closely consulted and coordinated with the

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[355] See the Appendix for the Commission's estimates of the funding costs for initial margin and variation margin, as well as a more detailed discussion of certain administrative costs.

[356] For the reasons discussed in the Appendix, these administrative costs are difficult to quantify at this time. Therefore, the Commission discusses the administrative costs related to margin for uncleared swaps qualitatively instead.

[357] That is, if the Commission's margin rules are substantially stricter than that of the Prudential Regulators, such difference could make it less costly to conduct swaps trading in a bank swap dealer as compared to a non-bank swap dealer. Likewise, U.S. and financial end users could be advantaged or disadvantaged depending on how the Commission's margin rule compares with corresponding requirements in other jurisdictions.

Prudential Regulators and foreign regulators in order to harmonize our respective margin rules to the greatest extent possible.[358]

The baseline against which the costs and benefits associated with this rule will be compared is the status quo, i.e., the uncleared swaps markets as they exist today. At present, swap market participants are not legally required to post either initial or variation margin when engaging in uncleared swaps. Nevertheless, the Commission understands that, for risk management purposes, many CSEs collect initial margin from certain non-CSE counterparties and exchange variation margin with CSEs and financial end users for uncleared swaps. Further, section 4s(e), read together with section 2(i) of the CEA,[359] applies the margin rules to a CSE's swap activities outside the United States, regardless of the domicile of the CSE (or its counterparties). Because the Commission found no information that indicates that there are material differences in the costs and benefits discussed herein between foreign and cross-border swaps activities of CSEs and financial end users affected by the rule, the Commission's consideration of the costs and benefits of the final rule applies to all swap activities, domestic and cross-border, to which the final rule applies. CSEs, wherever domiciled, by definition are involved in a large

[358] The Commission, in a separate rulemaking, will address the cross-border application of the Commission's margin rules, including the availability of substituted compliance and exclusion, as appropriate. The cross-border margin rules are intended to further promote global harmonization of margin rules and consequently, mitigate the potential for competitive distortions and market inefficiencies.

[359] See 7 U.S.C. 2(i). Section 2(i) of the CEA states:

> The provisions of this Act relating to swaps that were enacted by the Wall Street Transparency and Accountability Act of 2010 (including any rule prescribed or regulation promulgated under that Act), shall not apply to activities outside the United States unless those activities –
>
> (1) have a direct and significant connection with activities in, or effect on, commerce of the United States; or
>
> (2) contravene such rules or regulations as the Commission may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision of this Act that was enacted by the Wall Street Transparency and Accountability Act of 2010.

volume of swaps activity in, or significantly affecting, United States markets and are registered with the Commission. Accordingly, they can be expected already to have in place personnel and infrastructure for compliance with United States law. To the extent that there may be differences in the particulars of costs to foreign CSEs or financial end users, the record of this proceeding generally did not provide information that would permit the evaluation of any such differences.[360]

In the sections that follow, the Commission considers: (i) the costs and benefits associated with its choices regarding the scope and extent to which it would apply its margin rule to uncleared swaps of a CSE and certain financial end users; (ii) the alternatives considered by the Commission and the costs and benefits relative to the approach adopted herein; and (iii) impact of the margin rule on the market and the public, in light of the 15(a) factors, as applicable. In the proposing release, the Commission addressed the costs and benefits of the proposed rules, taking into account the considerations described above. The Commission also requested comments on these assessments and for any data or other information that would be useful in estimation of the quantifiable costs and benefits of this rulemaking. A total of 58 comment letters were received. Some commenters generally addressed the cost-and-benefit aspect of the proposed rule;[361] one commenter provided quantitative data and analysis of the Commission's proposal. The discussion of the costs and benefits that follows is largely

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[360] As foreign jurisdictions put in place their own margin rules in the future, the existence of these rules may affect the costs and benefits of the Commission's rules for foreign CSEs and financial end users. However, the still developing state of foreign law in this area and the absence of specific information in the record of this proceeding does not permit a detailed evaluation of such possible effects in the present proceeding. As noted above, the Commission will be addressing certain issues relating to the effects of foreign margin rules, including the availability of substituted compliance, in a separate rulemaking.

[361] As discussed in this release, the relevant comments have informed the Commission's decisions regarding the final rule and are highlighted below.

qualitative in nature, although where possible the Commission attempts to quantify these benefits and costs.

## B. Final Rule

### 1. Covered Entities: CSEs and Financial End Users

Margin requirements apply to uncleared swaps entered into by CSEs[362] -- and by extension, to the counterparties to such swaps. Because different types of counterparties can pose different levels of risk, the final rule establishes three categories of counterparty: (i) CSEs; (ii) financial end users; and (iii) non-financial end users. Under the final rule, the initial and variation margin requirements apply to uncleared swaps of CSEs with certain counterparties, namely, other CSEs, swap entities that are not a CSE and financial end users (and in the case of initial margin, only those financial end users with material swaps exposure).[363] The final rule defines "financial end user" as a counterparty that is not a swap dealer or a major swap participant but which falls within one of the categories of entities primarily engaged in financial activities.[364] These categories are nearly identical to the Prudential Regulators' definition of "financial end user."[365]

In developing the definition of financial end user, the Commission was mindful of the significant new costs associated with the new minimum collateral requirements and has attempted to tailor the definition carefully to avoid undue burden on market participants, without undermining the objectives of the margin rules. Accordingly, the

[362] As discussed above, however, certain uncleared swaps of CSEs with their affiliates are not subject to initial margin; the related cost-benefit considerations are addressed below.

[363] The Commission recognizes that a CSE may enter into a swap with another non-CSE swap entity, which would result in the non-CSE swap entity collecting under the Prudential Regulators' margin regime. Therefore, this section does not consider costs and benefits as they relate to the non-CSE swap entity.

[364] § 23.151.

[365] The Commission notes that its definition of "financial end user" includes security-based swap dealers and major security-based swap participants, as these entities are included in the Prudential Regulators' definition of swap entities.

definition is intended to capture those market participants that by the nature and scope of their financial activities present a higher level of risk of default and are integral to the financial system, and thus, pose greater risk to the safety and soundness of their CSE counterparties and the stability of the financial system. Consistent with this risk-based approach to the definition, the definition specifically excludes entities that may be considered financial in nature but that perform different functions in the financial system than those included in the definition of financial end user. These include, among others, multi-lateral development banks, the Bank for International Settlements, and a subset of financial entities that engage in swaps to hedge or mitigate commercial risks.

A number of commenters also requested that the Commission exclude from the financial end user definition structured finance vehicles, including securitization special purpose vehicles ("SPVs") and covered bond issuers.[366] These commenters argued that margin requirements on structured finance vehicles would restrict their ability to hedge interest rate and currency risk and potentially force these vehicles to exit the swaps market since these vehicles generally do not have ready access to liquid collateral. Other commenters argued that pension plans should not be subject to margin requirements because they are highly regulated, highly creditworthy, have low leverage and are prudently managed counterparties whose swaps are used primarily for hedging and, as such, pose little risk to their counterparties or the broader financial system.[367]

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[366] See SIFMA, SFIG and ISDA.

[367] See ABA (pension plans should not be subject to margin and should be treated as non-financial end users); AIMA (benefit plans should not be subject to margin and there is ambiguity involving whether non-U.S. public and private employee benefit plans would be financial end users); JBA (securities investment funds should be exempt from variation margin).

The Commission is not excluding, as commenters urged, pension plans, and structured finance vehicles. The Commission observes that these entities engage in the same range of activities as the other entities encompassed by the final rule's definition of financial end user. The Commission notes that the increase in the material swaps exposure threshold, as finalized in the final rule, should address some of the concerns raised by these commenters regarding the applicability of initial margin requirements.[368]

The enumerated list in the definition of financial end user is intended to provide enhanced clarity to ease the burden associated with determining whether a counterparty is a financial end user.[369] The Commission also considered alternative definitions, including using a broad-based definition similar to that listed in section 2(h)(7)(C) of the CEA. The Commission is not adopting this approach because it believes that it would be difficult for the market participants to implement and the Commission to monitor. In addition, the broad-based definition would not provide the level of clarity that an enumerated list provides market participants when engaging in uncleared swaps.

Initial margin requirements apply only to those financial end users that meet the specified MSE threshold. The MSE threshold is intended to identify entities that engage in significant derivatives activity as measured by the end user's overall exposure in the market. In the proposal, the Commission proposed to define materiality as $3 billion

[368] In addition, with respect to pension plans, the Commission notes that Congress explicitly listed employee benefit plans as defined in paragraph (3) and (32) of section 3 of the Employee Retirement Income Security Act of 1974 in the definition of "financial entity" in the Dodd-Frank Act. As a result, pension plans do not benefit from an exclusion from clearing even where they use swaps to hedge or mitigate commercial risk.

[369] In this regard, the Commission recognizes that the definition —particularly, the test that deems an entity a financial end user if it were organized under the laws of the United States—may impose a greater incremental cost with respect to foreign counterparties. However, the Commission believes that it is necessary to cover all financial end users that are counterparties to a CSE, including those that are foreign-domiciled, to effectuate the purposes of the margin requirements.

average notional amount. The final rule increases the level of the aggregate notional amount of transactions that gives rise to MSE to $8 billion, which is broadly consistent with the €8 billion established by the 2013 international framework and consistent with the EU and Japanese proposals. The increased MSE threshold should further reduce the number of financial end users subject to the initial margin requirement in relation to the Commission's proposal.

The final rule defines "material swaps exposure" as the aggregate notional amount of swaps not only of a particular entity, but also of its affiliates and subsidiaries. The Commission recognizes that calculation of MSE on an aggregate basis across affiliates and subsidiaries would require new reporting and tracking systems. As discussed above, the aggregation requirement is primarily intended to address the potential circumvention, as CSEs may disperse their swap activities through their affiliates to avoid exceeding the MSE threshold. The aggregation approach provides the Commission with a more complete picture of a firm's systemic risk profile by measuring the risk at the consolidated level. The Commission believes that aggregating exposure across affiliates is necessary to achieve the objectives of the margin requirements.

The definition of MSE also contains a number of other changes from the proposed definition to address commenters' concerns. Notably, in response to commenters, a financial end user needs to count only one side of an inter-affiliate swap in calculating its MSE. The Commission believes that double counting (as proposed) would result in an inaccurate measure of the swaps exposure of a financial end user as it would inflate the total exposure within the consolidated group. By modifying the calculation in this way, the Commission believes that it is reducing the number of financial end users with MSE, which should lessen the costs for financial entities that would have exceeded the $8 billion threshold.[370]

The final affiliate definition uses financial accounting standards as the trigger for affiliation, rather than a legal control test. The Commission believes that determining affiliate status based on whether a company is or would be consolidated with another company on financial statements prepared in accordance with U.S. GAAP, the International Financial Reporting Standards or other similar standards, reflects a more accurate method for discerning control and should be less burdensome to apply.[371] The Commission expects that most entities prepare financial statements under an acceptable accounting standard. For companies that do not prepare these statements, the Commission believes that industry participants are more familiar with the relevant accounting standards and tests, and they will be less burdensome to apply.

**2. Initial Margin**

Initial margin is intended to address potential future exposure. That is, in the event of a counterparty default, initial margin protects the non-defaulting party from the loss that may result from a swap or portfolio of swaps, during the period of time needed to close out the swap(s). Initial margin augments variation margin, which secures the current mark-to-market value of swaps. Under the final rule, CSEs would be required to both collect initial margin from and to post initial margin to financial end users with material swaps exposure. This represents a departure from current industry practice and

[370] The Commission made a similar change to the definition of "initial margin threshold amount" as described in Regulation 23.151.
[371] Commenters raised the concern that the proposed "control" test was difficult to apply and over-inclusive. See e.g., ACLI.

hence, introduces new costs for CSEs and their covered counterparties, but is in accordance with the BCBS-IOSCO framework and the Prudential Regulators' final rules.

These costs include the costs of the requisite collateral, namely, the cost of securing external funds or the foregone return from investments. It is difficult to estimate these costs due to the fact that funding costs would vary widely depending on the type of entities and their sources of liquidity, differences in funding costs over time, differences on their return on investments and differences in the rate of return on different collateral assets that may be used to satisfy the initial margin requirements, among other things.[372]

At one extreme, it may be that some entities providing initial margin, such as pension funds and asset managers, will provide assets as initial margin that they already own and would have owned even if no requirements were in place. In such cases the economic cost of providing initial margin collateral is anticipated to be low. In other cases, entities engaging in uncleared swaps will have to raise additional funds to secure assets that can be pledged as initial margin. The greater the costs of their funding, relative to the rates of return on the initial margin collateral, the greater the cost of providing collateral assets.[373]

At the same time, a two-way exchange of initial margin protects both the CSE and the financial end user from the build-up of counterparty credit risk from uncollateralized

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[372] Further, it is expected that due to the cost of the final rules, some market participants may be incentivized to use alternatives to uncleared swaps. Futures contracts and cleared swaps, which tend to be more standardized and liquid than uncleared swaps, typically require less initial margin; however, this may result in basis risk given the standardization of these products. A futures contract has a one day minimum liquidation time and a cleared swap has a three- to five-day minimum liquidation time; in contrast, under the final rule, a ten day minimum liquidation time is required for uncleared swaps.

[373] To the extent that the same funding could have been used to fund investment opportunities, there is also an opportunity cost on that lost investment.

credit exposures. As noted above, these entities are critical to the stability of the financial system and therefore, need the protection of initial margin in the event of the default of a CSE, as the potential of a cascading event is increased without the collection of initial margin by these financial end users. In regards to the CSE, posting margin restricts the CSE from accumulating too large of an exposure in relation to its financial capacity. Therefore, the two-way exchange of initial margin should increase the overall stability of the financial system.

Further, as a result of the reduced risk of default, the posting party could receive a benefit from changes to the relationship between the CSE and the counterparty. As a result of the reduction in the overall credit exposure with the CSE, the counterparty may be able to realize better credit terms when transacting with the CSE and it consolidated group. To the extent any such benefit is realized, it would offset a portion of the cost incurred in posting collateral.

Some commenters recommended that the Commission adopt a "collect-only" approach with respect to foreign end users.[374] In response, the Commission notes that, in contrast to the proposed Japanese and European margin regimes, which would cover a very broad array of financial entities, a collect-only regime under the U.S. regime would be applicable only to CSEs and thus could leave a large number of financial entities with significant uncollateralized future exposures to their swap dealers.[375]

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[374] See, e.g., ISDA.

[375] The Commission notes that under the latest EU proposal, if a counterparty to a European-registered entity is a non-European registered entity, then the European-registered entity must post initial margin to the non-European registered entity. See, Second Consultation Paper on draft regulatory technical standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012 (for the European Market Infrastructure Regulation) (Jun. 10, 2015), available at https://www.eba.europa.eu/documents/10180/1106136/JC-CP-2015-002+JC+CP+on+Risk+Management+Techniques+for+OTC+derivatives+.pdf.

The Commission is requiring that CSEs calculate initial margin on a daily basis and that initial margin be posted within one day after the date of execution. The Commission is adopting this approach to preserve the margin period of risk, e.g., 10 day calculation period for initial margin models. Daily calculation is necessary as the risk factors and the portfolio are subject to daily change. If the Commission were to adopt a less restrictive timeframe for posting initial margin, the margin period of risk would increase, reducing the protection provided by initial margin. The Commission considered adding days to the 10 day margin period of risk to account for the additional time given to post initial margin collateral; however, the Commission believes that it would be difficult to implement as models would need to be adjusted to account for different posting timeframes, which could create difficulties for the Commission in validating the initial margin model calculations.

The Commission recognizes that the T+1 posting requirement may lead to additional funding costs in the form of excess margin being held at the custodian to meet the one day requirement.[376] However, the Commission expects that counterparties will post cash or some other eligible assets that can be pledged in one day and subsequently substitute other eligible assets for these highly liquid assets, which should mitigate the burdens placed by this requirement. The Commission notes that it has modified the date of execution to account for different time zones and holidays to further reduce the burdens associated with the T+1 requirement.

Under the final rule, consistent with the BCBS-IOSCO standard, initial margin will not be required to be collected or posted by a CSE to its covered counterparty, to the

[376] The excess amount held at the custodian would only need to be the incremental change from day-to-day.

extent that the aggregate un-margined exposure to its covered counterparty remains below $50 million. In effect, the $50 million threshold will provide a certain level of relief to all counterparties that are required to post and collect initial margin. It should also serve to reduce the aggregate amount of initial margin - and consequently, incrementally reduce overall funding cost - of all covered counterparties. At the same time, the Commission recognizes that the $50 million threshold represents uncollateralized risk of potential future exposure. However, the Commission believes that this amount of uncollateralized swaps exposure, calculated on a consolidated basis within a corporate group, is acceptable in the context of initial margin, particularly in light of the benefits to the financial system. To further ease the transaction costs associated with the exchange of margin, the Commission is not requiring a CSE to collect or post any amount below the transfer amount of $500,000.[377]

3. **Calculation of Initial Margin**

Under the final rule, a CSE must calculate the required amount of initial margin daily, on the basis of either a risk-based model or a table-based method. The use of either model is predicated on the satisfaction of certain baseline requirements to ensure that initial margin is calculated in a manner that is sufficient to protect CSEs as intended. Further, the choice of two alternatives allows CSEs to choose the methodology that is the most cost efficient for managing their business risks and thereby better compete. The costs and benefits associated with the use of each approach are addressed below.

[377] This amount applies to both initial and variation margin transfers on a combined basis.

### (a) Risk-Based Model

Generally, the baseline requirements of this risk-based model reflect the current practice for calculating bank regulatory capital and value at risk ("VaR") and conform to the BCBS/IOSCO standard for calculating margin for uncleared swaps.[378] To the extent CSEs are familiar with these requirements and have infrastructure in place to calculate the initial margin amount under this model approach, burdens associated with utilizing the model should be mitigated.

Under this model, a CSE would be required to generally calculate their initial margin based on the assumption of a "holding period" of 10 business days with a one-tailed 99% confidence interval. The Commission believes that a 10 day close-out period is necessary to ensure that the non-defaulting party has sufficient time to close out and replace its positions in the event of counterparty default.[379] The Commission recognizes that certain swaps may not require a 10 day period to liquidate or replace and hence a 10 day close-out period may lead to excessive initial margin. However, the Commission expects that most of the instruments that could be liquidated in less than 10 days are

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[378] The same model requirements have been proposed by the EU, Japan, and Singapore. See "Consultation Paper: Draft regulatory technical standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012," available at https://www.eba.europa.eu/documents/10180/655149/JC+CP+2014+03+%28CP+on+risk+mitigation+for+OTC+derivatives%29.pdf; "Publication of draft amendments to the "Cabinet Office Ordinance on Financial Instruments Business" and "Comprehensive Guidelines for Supervision" with regard to margin requirements for non-centrally cleared derivatives," available at http://www.fsa.go.jp/news/26/syouken/20140703-3.html; and "Policy Consultation for Margin for Non-Centrally Cleared OTC Derivatives," available at http://www.mas.gov.sg/~/media/MAS/News%20and%20Publications/Consultation%20Papers/Policy%20Consultation%20on%20Margin%20Requirements%20for%20NonCentrally%20Cleared%20OTC%20Derivatives%201Oct.pdf.

[379] Studies on capital requirements conducted by BCBS-IOSCO have shown that a 10 day margin period of risk is adequate to address the moves in the market. See "Margin Requirements for Non-Centrally Cleared Derivatives," BCBS-IOSCO, Sept. 2013, available at http://www.bis.org/publ/bcbs261.pdf.

currently being cleared, and therefore, the impact of the requisite 10 day close-out period may be limited. Moreover, the Commission believes that under market stress, these same instruments that may be replaced or liquidated in less than 10 days may not maintain that same level of liquidity.

The Commission considered the alternative of setting the individual margin period of liquidation for separate instruments or by broad asset class. However, under these alternatives, there would be substantial operational burdens on market participants in determining the appropriate margin period of risk for each individual swap or broad asset class. Substantial burdens would be imposed on regulators as well as they would be required to review each CSE's determination of appropriate liquidation periods, which would not be uniform across each CSE for each individual swap or asset class, resulting in disputes as a result of each CSE determining its own liquidation period for the specific swap or swap asset class.

The Commission is also requiring that the data used in calculating initial margin be based on an equally-weighted historical observation period of at least 1 year and not more than 5 years, and must incorporate a period of significant financial stress for each broad asset class that is appropriate to the uncleared swaps to which the initial margin model is applied. The Commission believes that this approach would give an estimation period that is more representative of the underlying risks over time and thus, mitigate the pro-cyclical nature of initial margin calculations. In addition, under the final rule, the initial margin model must be recalibrated on an on-going basis to incorporate any change that results from a current period stress. The Commission believes that this aspect of the final rule is necessary as the initial margin calculated without a period of financial instability would not be adequate to ensure the safety and soundness of CSEs or the stability of financial markets during a period of significant market volatility. The Commission understands that this stress period element may increase the level of initial margin required; however, in a time of stress, any change in the required margin amount should be not be pro-cycle, as the amount requirement would already contain a period of stress.

Under a risk-based model, offsetting risk exposures for a swap may be recognized only in relation to another swap in the same category; offsetting risk exposures may not be recognized across asset classes. This will result in a greater amount of initial margin, all things being equal. The Commission is concerned that cross-asset class correlations break down during times of stress, increasing the likelihood that in the event of default, the initial margin amount calculated using these correlations would be insufficient to cover the amount needed to replace the positions.

The risk-based model must also include material risks arising from non-linear price characteristics, as many swaps have optionality. The Commission understands that this requirement may increase costs in developing models and result in a greater amount of initial margin. However, the Commission believes that without this requirement the initial margin calculation would not be adequate to cover the inherent risks of the swap or a portfolio of swaps. Moreover, the Commission understands that these risks are already imputed in the price of the swap. Therefore, the incremental burden should be minimal.

A CSE using a risk-based model to calculate initial margin would be required to establish and maintain a rigorous risk controls process to re-evaluate, update, and validate the model as necessary to ensure its continued applicability and compliance with the baseline requirements. While certain of these measures may already be in place as part of a CSE's risk management program (established under section 23.600(c)(4)(i)), others will result in additional costs for CSEs.[380] The Commission believes that these measures are essential to ensuring the efficacy of risk-based models used by CSEs. In addition, given that a CSE subject to the Commission's margin rules may be affiliated with one or more prudentially-supervised swap entities, the Commission would closely coordinate with the Prudential Regulators for expedited review of the model. The expedited review process should reduce unnecessary delay or duplication.[381]

**(b) Standardized Approach**

As an alternative to a risk-based model, a CSE may calculate initial margin using a standardized table. The standardized approach could result in excess initial margin being calculated. For this reason, the standardized approach is likely to appeal to those CSEs with smaller swap portfolios with limited offsets, for whom a risk-based margin model would not be cost-effective. Since many CSEs and financial end users with material swaps exposure tends to have large swaps positions with significant offsets, the Commission expects that the risk-based model will be more widely favored.

**(c) Netting**

Netting should reduce overall initial margin in relation to initial margin that would result from a calculation based on a gross measure. Both the formula employed in the standardized method and the approach of the risk-based model require that offsets be

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[380] See § 23.504(b)(4).
[381] Additionally, the final rule provides that a CSE may use models that have been approved by NFA.

reflected only for swaps that are subject to the same eligible master netting agreement ("EMNA"). The eligibility criteria for netting are consistent with industry standards currently being used for bank regulatory capital purposes,[382] which should reduce the administrative costs that would be incurred in connection with any renegotiation of the terms of existing netting agreements.

A number of commenters argued that, in order to allow close-out netting and contain costs, the final rule should not require new master agreements to separate pre- and post-compliance date swaps, and that parties should be permitted to use credit support annexes that are part of the EMNA instead of new master agreements to distinguish pre-and post-compliance date swaps.[383] In response to commenters, the final rule provides that an EMNA may identify one or more separate netting portfolios that independently meet the requirement for close-out netting[384] and to which, under the terms of the EMNA, the collection and posting of margin applies on an aggregate net basis separate from and exclusive of any other uncleared swaps covered by the agreement. This rule should facilitate the ability of the parties to document two separate netting sets, one for uncleared swaps that are subject to the final rule and one for swaps that are not subject to the margin requirements. A netting portfolio that contains only uncleared swaps entered into before the applicable compliance date is not subject to the requirements of the final rule.

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[382] See 12 CFR part 3.2, 12 CFR part 217.2, and 12 CFR part 324.2. Regulatory Capital Rules, Liquidity Coverage Ratio: Interim Final Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions, 79 FR 78287 (Dec. 30, 2014).
[383] See TIAA-CREF; CPFM; ICI; SIFMA; ISDA; SIFMA-AMG; ABA; JBA; CS; AIMA; MFA; FSR; Freddie; ACLI; and FHLB.
[384] See § 23.151 (paragraph 1 of the EMNA definition).

Notably, for an agreement to qualify as an EMNA, the CSE must conduct sufficient legal review to conclude with a well-founded basis that the agreement, among other things, would be legal, valid, binding, and enforceable under the law of the relevant jurisdictions. The Commission recognizes that the requisite "sufficient legal review" will require, as a practical matter, a legal opinion, which will adversely affect costs for CSEs. Additionally, to the extent that a "sufficient legal review" cannot be obtained (e.g., because the foreign jurisdiction is lacking in comparable close-out netting arrangements), a CSE would need to collect and post on a gross basis. Nevertheless, given the importance of a legally binding and enforceable netting arrangement in the event of default, the Commission is retaining the legal review requirement.

Finally, CSEs may include legacy swaps in the same EMNA through the use of multiple CSAs. This approach would allow CSEs to preserve the benefit of close-out netting with all their swaps with a specific counterparty. However, legacy swaps may not be included when multiple CSAs are used in calculating the initial margin amount for that counterparty. The Commission designed this approach to prevent cherry-picking as a CSE could select specific legacy trades that would reduce the amount of initial margin required on any certain day.

**4. Variation Margin**

Variation margin provides an important risk mitigation function by preventing the build-up of total uncollateralized credit exposure of outstanding uncleared swaps. Under the final rule, a CSE must collect variation margin from or pay variation margin to its counterparty on or before the business day after the date of execution of an uncleared swap. Variation margin would be required for all financial end users, regardless of whether the entity has material swaps exposure. In this regard, the final rule is consistent with the Prudential Regulators' rules and the 2013 International Standards. In addition, the Commission is requiring a daily, two-way exchange of variation margin since mark-to-market is based on unrealized gains of either party (i.e., if one party has an unrealized gain, the other party has an unrealized loss).

The exchange of variation margin would result in additional costs to CSEs and financial end users that currently are exchanging variation margin or exchanging variation margin less frequently than daily. These financial entities may also need to adjust their portfolio to ensure the availability of eligible collateral for exchanging variation margin.[385]

The final rule requires certain control and validation mechanisms for the calculation of variation margin to ensure that the variation margin calculated would be adequate to cover the current exposure of the uncleared swaps, including the requirement to create and maintain documentation setting forth the CSEs' calculation methodology with sufficient specificity to allow the counterparty, the Commission and any applicable Prudential Regulator to calculate a reasonable approximation of the margin requirement independently; and evaluate the reliability of its data sources at least annually, and make adjustments, as appropriate. Implementation of these measures will result in additional costs to CSEs. Nevertheless, the Commission is adopting these control and validation mechanisms as they are necessary to ensure the accuracy of the variation margin calculation methodology used by a CSE.

[385] The next section discusses the expanded eligible collateral for variation margin.

There are, however, several factors that should have a mitigating effect on the cost of variation margin. First, as discussed below, the final rule expands the list of eligible collateral for non-CSE financial end users, which may reduce funding costs. In addition, the final rule will include a minimum transfer threshold of $500,000, which should mitigate some of the administrative burdens and counter-cyclical effects associated with the daily exchange of variation margin, without resulting in an unacceptable level of uncollateralized credit risk. In addition, competitive disparities may be lessened by the fact that daily exchange of variation margin is required with respect to all financial end users under both the final rule and international standards.

**5. Eligible Collateral**

Limiting eligible collateral to the most highly liquid categories could limit the potential that a CSE would incur a loss following default of a counterparty based on changes in market values of less liquid collateral that occur before the CSE is able to sell the collateral, and therefore could limit the potential for a default by the CSE to other counterparties. On the other hand, an overly restrictive eligibility standard could have the effect of draining liquidity from the counterparty in a way that may not be necessary to account for the CSE's potential future exposure to the counterparty, and may increase costs for both counterparties.[386] The Commission considered these competing concerns in developing the list of eligible collateral.

For example, the Commission is allowing certain equities as eligible collateral to prevent adverse effect on investment returns for collective investment vehicles, insurance

[386] This could also lead to a greater demand on a relatively few instruments.

companies, and pension funds.[387] To accommodate the concern of certain commenters that argued for an inclusion of money market mutual funds and bank certificates of deposit in the list of eligible collateral for initial margin, the final rule also adds redeemable securities in a pooled investment fund that holds only securities that are issued by, or unconditionally guaranteed as to the timely payment of principal and interest by, the U.S. Department of the Treasury, and cash funds denominated in U.S. dollars.

Although the Commission received several comments concerning the proposal's treatment of the securities of certain GSEs, only modest changes have been made in the final rule. The Commission continues to believe the final rule should treat GSE securities differently depending on whether or not the GSE enjoys explicit government support, in the interests of both the safety and soundness of CSEs and the stability of the financial system.[388] In other words, the treatment of GSE securities by market participants as if those securities were nearly equivalent to Treasury securities in the absence of explicit Treasury support creates a potential threat to financial market stability, especially if vulnerabilities arise in markets where one or more GSEs are dominant participants, as occurred during the summer of 2008. The final rule's differing treatment of GSE collateral based on whether or not the GSE has explicit support of the U.S. government helps address this source of potential financial instability and recognizes that securities issued by an entity explicitly supported by the U.S. government might well perform better during a crisis than those issued by an entity operating without such support.

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[387] See, e.g., ICI; ISDA; CPFM; GPC; SIFMA-AMG; IECA; Freddie; and CDEU.

[388] Section [ ] discusses in detail the final rule's treatment of GSEs in the context of eligible collateral.

In addition, the final rule prohibits the use of certain assets as collateral because their use might compound risk, i.e., wrong way risk. The list of prohibited assets include instruments that represent an obligation of the party providing such asset or an affiliate of that party and instruments issued by bank holding companies, depository institutions, systemically important financial institutions, and market intermediaries. The Commission notes that the price and liquidity of securities issued by these entities are likely to lose value at the same time that the counterparty's obligation under the swap increases, resulting in an additional increase in risk. For this reason, notwithstanding the additional funding costs that may result, the Commission believes that including these instruments as eligible collateral would be inappropriate.

Under the final rule, for swaps between a CSE and a financial end user, the Commission is expanding the form of eligible collateral that can be posted for variation margin to accommodate the assets held by the affected financial end users. The Commission believes that this should mitigate the potential for investment drag of financial end users, as well as mitigate the pro-cyclical effects potentially resulting from restricting eligible collateral to cash.

As noted above, the Commission is limiting eligible collateral to cash for variation margin between CSEs since these entities pose a significant level of risk to the financial system and cash is the most liquid asset and holds its value in times of stress. Since CSEs currently exchange variation margin in cash, the cash-only requirement could have minimal impact on CSEs. On the other hand, the Commission understands that, in times of stress when cash may be difficult to obtain, it is possible that CSEs may be cash constrained and therefore, could fall into a technical default. The Commission considered these competing concerns in developing this requirement.

The Commission is adopting standardized haircuts on instruments other than cash.[389] For example, in the case where equities are used as eligible collateral, there is a requirement for a minimum 15 percent haircut on equities in the S&P 500 Index and a minimum 25 percent haircut for those in the S&P 1500 Composite Index but not in the S&P 500 Index.[390] The Commission is not allowing CSEs to use internal models to calculate haircuts on eligible collateral. The Commission recognizes that, as a result, more assets would be required to be posted as margin, which may result in additional funding costs.[391] On the other hand, a more conservative approach reflected in the final rule would result in a greater amount of assets posted, which provides a greater buffer to cover losses in the event of a default.

**6. Segregation**

Posted collateral must be properly protected in order to avoid undermining the benefits of the margin requirements. The Commission understands that, to the extent that the final rule's segregation requirements diverge from existing industry practices, CSEs may incur substantial administrative costs.

Under the final rule, required initial margin must be kept in accordance with the following: 1) all funds collected and posted as required initial margin must be held by a third-party custodian (unaffiliated with either counterparty to the swap); 2) the third-

[389] The Commission recognizes that these haircuts apply to certain currencies, under certain circumstances.
[390] As discussed in the Appendix, the Commission recognizes that due to certain investment constraints, including regulatory limitations, not every financial entity is going to be able to pledge all types of eligible collateral, which will have an effect on its funding costs of collateral.
[391] The Commission would expect that under the model based approach, calculated haircut would be less than the standardized haircut approach.

party custodian is prohibited from re-hypothecating, re-using, or re-pledging (or otherwise transferring) the initial margin; 3) the initial margin collected or posted may not be reinvested in any asset that would not qualify as eligible collateral; and 4) the custodial agreement is legal, valid, binding and enforceable in the event of bankruptcy, insolvency, or similar proceedings.

While several commenters supported the mandated use of a third-party custodian, others objected, citing concerns about complexities that additional parties bring to the relationship, as well as increased costs arising from the negotiation of custodial contracts and the cost of developing operational infrastructure as using a third-party custodian is not the current practice for certain financial entities.[392] The Commission is also aware that many custodians are affiliated with one or more CSE or financial end users; as a result, the mandated use of a third-party custodian may lead to collateral assets being held at a limited number of custodians.

The Commission believes that it is necessary to require the use of an independent third-party custodian to safeguard required initial margin in order to best ensure that those assets would be available to the non-defaulting counterparty in the event of a counterparty default. A custodian that is affiliated with either counterparty to a swap raises the concern that in the event of a default by its affiliate counterparty, the custodian's affiliation may compromise its ability to act swiftly to release funds to the non-defaulting counterparty. As to concerns regarding the high concentration of custodians that could result from the independence element, the Commission notes that segregated accounts would be protected - regardless of the concentration level of

[392] See GPC.

custodians - as they would not be part of the estate of the defaulting custodian under the current bankruptcy regime.

Several commenters recommended lifting the restriction on rehypothecation and reuse of initial margin collateral, either generally or on a conditional basis.[393] The Commission is not allowing the rehypothecation of initial margin collateral. Rehypothecation would allow the collateral posted by one counterparty to be used by the other counterparty as collateral for additional swaps, resulting in rehypothecation chains and embedded leverage throughout the financial system. The increased leverage, along with the additional connections between market participants, resulting from rehypothecating margin, could have a destabilizing effect on the financial system.[394] The Commission understands that prohibition against rehypothecation will impose significant costs on market participants as this will increase their funding costs for margin.

The Commission is not allowing cash to be posted as initial margin collateral without it being converted into other eligible collateral. As noted above, cash held at a custodian in a deposit account can be used by the custodial bank and as such, posting of cash as initial margin would run afoul of the prohibition against rehypothecation. This requirement may lead to additional funding costs in the form of excess margin being held at the custodian. However, the Commission expects that counterparties will post some other form of eligible collateral and subsequently substitute the cash with other eligible

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[393] See CPFM; CCMR; IFM; ISDA; SIFMA; ABA; CS; and FSR.

[394] For example, a default or liquidity event that occurs at one link along the rehypothecation chain may induce further defaults or liquidity events for other links in the rehypothecation chain as access to the collateral for other positions may be obstructed by a default further up the chain. Also, in the event of one default along the chain, there is an increased chance that each party along the chain will ask for the rehypothecated collateral to be returned to them at the same time, leaving just one party with the collateral. This spiraling event is the result of only one asset being pledged for all the positions along the rehypothecation chain.

assets, including a sweep vehicle, which should mitigate the burdens placed by this requirement.

### 7. Documentation

Comprehensive documentation of counterparties' rights and obligations to exchange margin allows each party to manage risks more effectively throughout the life of the swap and to avoid disputes regarding the terms of the swap during times of financial turmoil. In furtherance of that goal, the final rule requires that CSEs enter into contractual documentation with counterparties addressing, among other things, how swaps would be valued for purposes of determining margin amounts, and how valuation disputes would be resolved. To the extent that other Commission regulations address similar requirements, burdens on CSEs should be minimal.

### 8. Non-Financial End Users

The Commission's proposal did not require CSEs to exchange margin with non-financial end users as the Commission believes that such entities, which generally are using swaps to hedge commercial risk, pose less risk to CSEs than financial entities. Instead, the proposal would have required a CSE, for transactions with non-financial end users with material swaps exposure to such CSE, each day to calculate both initial and variation margin as if they were a CSE. These calculations would serve as risk management tools to assist the CSE in measuring its exposure and to assist the Commission in conducting oversight of the CSE. The majority of commenters opposed the hypothetical margin calculation requirement for non-financial end users.[395] Commenters generally noted the significant burdens this requirement may place on CSEs

[395] See ISDA; SIFMA; Joint Associations; JBA; FSR; ETA; NGCA/NCSA; CDEU; COPE; BP; Shell TRM; and CEWG.

and the non-financial end user, who must monitor their swaps exposures to determine if they exceed the material swaps exposure threshold.

In response to the comments, the Commission is not adopting the hypothetical margin calculation requirements concerning non-financial end users. Although the Commission continues to believe that hypothetical margin calculation requirements would promote the financial soundness of CSEs, the Commission recognizes the additional administrative burdens such measure could impose on CSEs and on non-financial end users. The Commission has determined that removing the hypothetical margin calculation is appropriate, particularly in light of the comprehensive risk management program that all CSEs are required to establish and maintain under existing Commission regulations.[396]

The proposal also would have required documentation between a CSE and a non-financial end user to state whether margin is required to be exchanged and, if so, the applicable thresholds below which margin is not required. In response to commenters' concern that the standards are too burdensome and that other Commission regulations adequately address the subject, the Commission is not adopting any new documentation requirement for uncleared swaps with non-financial end users.[397]

**9. Inter-Affiliate Swaps**

Under the final rule, the Commission is requiring the exchange of variation margin for swaps between a CSE and its affiliate. Initial margin is required to be collected from an affiliate if the affiliate is in a jurisdiction without comparable margin

[396] See, e.g., § 23.600 of the Commission's regulations.
[397] See ISDA.

requirements with respect to the affiliate's outward-facing (i.e., third-party) transaction. In addition, where the risk is being transferred to the CSE through a chain of inter-affiliate swaps, with the risk originating from a third-party transaction, that third-party transaction must be subject to comparable margin requirements with respect to that particular transaction; otherwise, the CSE must collect initial margin from its affiliate counterparty.

The Commission understands that CSEs currently exchange variation margin when entering into swaps with their affiliates. Therefore, the Commission expects that CSEs will incur incremental costs associated with funding variation margin under the final rule. Because the Commission in most cases is not requiring posting and collection of initial margin for inter-affiliate swaps, this may result in a CSE, in the event of a default of an affiliate counterparty (or the default of any of the affiliates in a chain of inter-affiliate swaps that has a cascading effect), not having enough margin to cover its losses on an inter-affiliate swap. However, viewed as a consolidated entity, the overall risk to the entity and the financial system, in terms of credit risk and leverage, should not be increased, as a result of the Commission's requirement, as the affiliate entering into an outward-facing swap must collect margin or the CSE must collect margin from its affiliated counterparty. In addition, as these inter-affiliate trades are typically designed to move risk to the most liquid market (in terms of breath and depth), this will permit the CSE to efficiently manage that risk. In addition, by not posting initial margin on their inter-affiliate swaps, the affected affiliates may compete more effectively by passing the cost savings to clients.

The Commission believes that the Prudential Regulators' approach, which requires swap dealers subject to the Prudential Regulators' margin rules to collect only for initial margin, would be too costly to the extent that the subject inter-affiliate trade is viewed as shifting risks within the consolidated group. This difference may make it less costly to conduct inter-affiliates swaps for Commission-regulated swap dealers than prudentially regulated swap dealers and CSEs. As a result of higher costs in transacting with prudentially regulated swap dealers than CSEs, the consolidated parent would favor inter-affiliates swaps with a CSE over a prudentially regulated swap entity.

**10. Compliance Schedule**

As discussed above, the Commission expects that affected entities will need to update their current operational infrastructure to comply with the provisions of the final rule, including potential changes to internal risk management and other systems, netting agreements, trading documentation, and collateral arrangements. In addition, the Commission expects that CSEs that opt to calculate initial margin using an initial margin model will modify such models and obtain regulatory approval for their use.[398] In this regard, the Commission recognizes that CSEs and other affected counterparties can benefit from additional time to come into compliance with the new margin regime; at the same time, it is important that the final rule is implemented without undue delay so as to protect CSEs and the U.S. financial system as Congress intended. Accordingly, the Commission has determined to adopt a phase-in schedule for compliance.[399] The phase-in

[398] The Commission understands that under current practices, CSEs already use models to calculate initial margin requirements for certain clients, including hedge funds.

[399] See § 23.161.

schedule is also responsive to commenters supporting international harmonization of implementation dates for margin requirement.

Under the phase-in schedule, the largest and most sophisticated covered swap entities that present the greatest potential risk to the financial system comply with the requirements first. The Commission expects that this would be less of a burden on these entities as they currently have the infrastructure in place to meet the requirements and would require the least amount of modification.

**C. Section 15(a) Factors**

**1. Protection of Market Participants and the Public**

Under the final rule, the market and the public will benefit from the required collateralization of uncleared swaps. More specifically, the margin requirements should mitigate the overall credit risk in the financial system, reduce the probability of financial contagion, and ultimately reduce systemic risk.

The primary reason for collecting margin from counterparties is to protect an entity in the event of its counterparty default. That is, in the event of a default by a counterparty, margin protects the non-defaulting counterparty by allowing it to use the margin provided by the defaulting entity to absorb the losses and to continue to meet all of its obligations. In addition, margin functions as a risk management tool by limiting the amount of leverage that either counterparty can incur. Specifically, the requirement to post margin ensures that each counterparty has adequate collateral to enter into an uncleared swap. In this way, margin serves as a first line of defense in protecting an entity from risk arising from uncleared swaps, which ultimately mitigates the possibility of a systemic event.

Protecting financial entities from the risk of failure has direct benefit to the public as the failure of these entities could result in immediate financial loss to its counterparties or customers. Given the importance of these entities to the financial system, their failure could spill over to other parts of the broader economy, with detrimental impact on the general public.

The final rule may also have the effect of promoting centralized clearing. Specifically, the final rule's robust margin requirements for uncleared contracts may create incentives for participants to clear swaps, where available and appropriate for their needs.[400] Central clearing can provide systemic benefits by limiting systemic leverage and aggregating and managing risks by a central counterparty.

On the other hand, required margin may reduce the availability of liquid assets for purposes other than posting collateral and therefore affect the ability of CSEs to engage in swaps activities and financial end users to manage or hedge the risks arising from their business activities. In addition, as detailed below in the Appendix, the Commission's margin requirements will increase the cost of entering into a swap transaction. The final margin rule incorporates various cost-mitigating provisions—such as the initial margin thresholds, expansion of eligible collateral for variation margin for financial end users, and minimum transfer amount—to contain potentially adverse impacts on the market and the public.

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[400] As a result of the cost effects on the Commission's final rule, it is expected that some market participants may change their practice of using uncleared swaps to alternative instruments. Futures and cleared swaps, which tend to be more standardized and liquid than uncleared swaps, typically require less initial margin; however, this may result in basis risk, as a result of standardization of these products. A futures contract has a one day minimum liquidation time. A cleared swap has a three to five day minimum liquidation time whereas the Commission's margin rules requires a ten day minimum liquidation time for uncleared swaps.

### 2. Efficiency, Competitiveness, and Financial Integrity of Swap Markets

In finalizing the rule, the Commission strived to promote efficiency and financial integrity of the swaps market, and where possible, mitigate undue competitive disparities. Most notably, the Commission, in finalizing the margin rule, aligned the rule with that of the Prudential Regulators to the greatest extent possible. This should promote greater operational efficiencies for those CSEs that are part of a bank holding company as they may be able to avoid creating individualized compliance and operational infrastructures to account for the final rule and instead, rely on the infrastructure supporting the bank CSE.

The final rule also provides for built-in flexibilities that should enhance the efficiency in the application of the rule. For example, the final rule provides counterparties the flexibility to post a variety of collateral types to meet the margin requirements which may result in increased efficiencies for end users and promote the use of swaps to hedge or manage risks. For initial margin calculation methodology, the final rule provides CSEs with the choice of two alternatives to allow them to choose the methodology that is the most cost efficient for managing their business risks.

Proper documentation of swaps is crucial to reducing risk in the bilaterally-traded swaps market. Accordingly, the final rule requires that CSEs enter into contractual documentation with counterparties addressing, among other things, how swaps would be valued for purposes of determining margin amounts, and how valuation disputes would be resolved. Documentation of counterparties' rights and obligations to exchange margin should allow each party to manage risks more effectively throughout the life of the swap and to avoid disputes regarding the terms of the swap during times of financial turmoil.

The safety and soundness of CSEs - given the nature and scope of their activities - are critical to the financial integrity of markets. As discussed above, margin serves as a first line of defense to protect a CSE in the event of a default by its counterparty. It also helps to reduce the risk of a systemic event by containing the risk of a cascade of defaults occurring. A cascade occurs when one participant defaulting causes subsequent defaults by its counterparties, and so on, resulting in a domino effect and a potential financial crisis.

The Commission also notes that the final margin rule, like other requirements under the Dodd-Frank Act, could have a substantial impact on the relative competitive position of market participants operating within the United States and across various jurisdictions. U.S. or foreign firms could be advantaged or disadvantaged depending on how the Commission's margin rule compares with corresponding requirements under Prudential Regulators' margin regime or in other jurisdictions. To mitigate undue competitive disparities, the Commission, in developing the final rule, harmonized the final rule with those of the Prudential Regulators and the BCBS-IOSCO framework.

**3. Price Discovery**

The Commission is requiring a ten-day margin period of risk for uncleared swaps, as compared to a three- to five-day margin period of risk for cleared swaps. Also, the Commission is only allowing limited netting for uncleared swaps. Together, these provisions of the final rule may result in the use of more standardized products.

Increase in the use of standardized products may lead to greater transparency in the cleared swaps and futures markets. If market participants migrate to standardized products, price discovery process for such swaps and futures may improve with higher volumes. Conversely, lower volumes for uncleared swaps may negatively impact the price discovery process for such swaps. However, the Commission believes that since these uncleared swaps are customized, the potential reduction in the efficacy of the price discovery process for uncleared swaps is less of a concern.

**4. Sound Risk Management Practices**

A well-designed risk management system helps to identify, evaluate, address, and monitor the risks associated with a firm's business. As discussed above, margin plays an important risk management function. Initial margin addresses potential future exposure. That is, in the event of a counterparty default, initial margin protects the non-defaulting party from the loss that may result from a swap or portfolio of swaps, during the period of time needed to close out the swap(s). Initial margin augments variation margin, which secures the current mark-to-market value of swaps. This, in turn, forces market participants to recognize losses promptly and to adjust collateral accordingly and helps to prevent the accumulation of large unrecognized losses and exposures.

The final rule permits CSEs to calculate initial margin by using either a risk-based model or standardized table method. The choice of two alternatives may enhance a CSE's risk management program by allowing the CSE to choose the methodology that is the most effective for managing their business risks.

The Commission is also requiring a ten-day margin period of risk for uncleared swaps and only a five-day margin period of risk for cleared swaps. Thus, the rule may result in the use of more standardized cleared swaps at the expense of more customized swaps which may be harder to evaluate and risk manage; however, this may encourage market participants to use less ideal hedging techniques, as noted above, which may result in a different type of risk at a firm.

Finally, the Commission is imposing strong model governance, oversight and control standards that are designed to ensure the integrity of the initial margin model and provide margin requirements that are commensurate with the risk of uncleared swaps. For the foregoing reasons, the final rule promotes sound risk management practices by CSEs.

### 5. Other Public Interest Considerations

The Commission has not identified any additional public interest considerations related to the costs and benefits of the final rule.

## Appendix A

In this Appendix, the Commission provides its estimate of the funding costs related to the final initial and variation margin requirements and discusses certain key aspects of overall administrative costs. As noted below, there are a number of challenges presented in conducting a quantitative analysis of the costs associated with the final rule. In this exercise, the Commission looked to data sources that were representative of the current swaps market and scaled the data to limit its estimate to CSEs and their uncleared swaps. Given the complexity of this final rule and its inter-relationship to other rulemakings, the Commission's estimate is subject to considerable uncertainty. The Commission's estimates are based on available data and assumptions set out below.

In the proposal, the Commission requested commenters to provide data or other information that would be useful in estimation of the quantifiable costs and benefits of this rulemaking. No commenters, with the exception of NERA, provided any data; NERA provided its estimate of the overall costs of the margin requirements under the Prudential Regulators' and Commission's proposed rules.[401] The Commission's estimate of the funding cost of initial margin diverges from that of NERA, as explained below.

## I. Margin Costs

### A. Funding Cost

The Commission reviewed various industry studies estimating the total cost of initial margin that would be required by the margin rules, as proposed, by the Prudential

[401] NERA provided recommendations for reducing the costs for the final rule; these recommendations are discussed above.

Regulators and the CFTC.[402] These studies rely on a different set of assumptions in calculating the funding costs of the margin rules, as explained below. The Commission used this set of industry data, which provides global estimates of the margin required under such rules, to construct its own estimates of costs. The cost estimates include two major components. The first component is an estimate of the amount of initial margin subject to the Commission's margin regime, constructed by scaling the global estimates of the margin to the relevant basis. The second component is an annual funding cost. The Commission multiplied these two components in order to obtain an annual cost of funding margin as required by the rules. This methodology is similar to that used by the Prudential Regulators in their quantitative analysis in finalizing their margin rules. Details of the methodology are described in the text that follows.

Table A, below, presents estimated amounts of initial margin that would be required for CSEs under the final rule.[403] These estimates are based on the assumption that the final rule is effective (i.e., in the post-transitional period).

The initial margin estimates in Table A are based on two different studies that estimate the potential impact of the 2013 international framework: BCBS and IOSCO[404]

[402] As discussed below, these studies did not distinguish between CSEs and prudentially-regulated swap dealers.

[403] The Commission is unable to quantify certain swaps that may fall under the final rule. Specifically, there are swaps entered into by some non-U.S. swap dealers and foreign counterparties that would be swept into this rulemaking under a 2(i) analysis (relating to the Commission's authority to regulate cross-border swaps) that are not reported. The Commission acknowledges that these costs are not reflected in the Commission's estimates because the Commission does not require regulatory reporting of all transaction data on swaps transacted globally by derivatives dealers covered by the rule. Hence, the Commission notes the limitation of the estimates shown in Table A, but is unable to make a reasonable estimate of the notional amount of derivatives not covered by its estimates.

[404] See Basel Committee on Banking Supervision and the International Organization of Securities Commissions (2013), *Margin Requirements for Non-Centrally Cleared Derivatives: Second Consultative Document*, report (Basel, Switzerland: Bank for International Settlements, February ).

and ISDA[405] studies. Each study reports an estimate of the global impact of margin requirements, which is displayed under the column heading "Global ($BN)." Most notably, these studies provide estimates based on the assumption that margin requirements apply to all uncleared swaps of all market participants covered by the 2013 international framework.

To estimate the funding costs of the initial margin requirement, the Commission modified the ISDA and BCBS IOSCO survey estimates in two stages. In the first stage, the Commission multiplied the survey estimates by 57% to align the global estimates better with the impact of the U.S. rules. The Commission utilized Swap Data Repository (SDR) data on uncleared interest rate swaps, which represent the majority of the notional value associated with uncleared swaps, to compute the 57% scale factor. The 57% scaling is designed to represent the notional amount of uncleared interest rate swaps reported to the SDRs as a fraction of the global notional amount of uncleared interest rate swaps represented in the surveys. The Commission's Weekly Swaps Report shows $100.9 trillion in notional outstanding for uncleared interest rate swaps reported to SDRs as of June 5, 2015, whereas the BCBS-IOSCO survey represents $175.6 trillion in global notional outstanding of uncleared interest rate swaps. Hence, the ratio between the two is approximately 57% (100.9/175.6 = 57.46%). The Commission applied this 57% scale factor to the global notional amount of margin estimated in each of the surveys.[406]

[405] Documents on initial margin requirements are available on the International Swaps and Derivatives Association website.

[406] The BCBS-IOSCO survey estimate is based on a global notional amount outstanding of $281.3 trillion of uncleared swaps. We apply the ratio 100.9/175.6 = 57% to each of the global margin figures to reduce them to the relevant basis for the rule.

These estimates inherit the limitations of the global estimates provided by the underlying studies, which applied rules that are similar, but not identical, to the Commission's rules. For example, the BCBS-IOSCO survey results do not apply the $8 billion material swaps exposure threshold, and in fact did not apply any such threshold. It also did not exclude swaps with a non-financial end user as a counterparty. The results are likely to be conservative and overstate the actual impact of the U.S. rules.

In a second stage, the Commission multiplied the results obtained in the first stage by 25%. This 25% scale factor reduces the estimates to account for the narrower scope of the Commission's rule as compared to the scope of SDR data. For a variety of reasons, many of the uncleared swaps reported to the SDRs do not require margin under the Commission's rule. For example, margin may instead be required under the Prudential Regulators' rule. Alternatively, margin would not be required if a covered swap entity's counterparty to a swap is a non-financial end user. The Commission has used SDR data to compute this 25% scale factor applied in its cost estimates. This scale factor is computed by comparing the notional amount of swaps covered by the Commission's rule to the total notional amount represented by SDR data.[407] The Commission believes that 25% is an appropriate scale factor to adjust the total notional value of uncleared swaps, reported to the SDR, to the relevant notional value.

[407] For the purposes of this calculation, the impact of the $8 billion material swaps exposure threshold for financial end users was approximated in the following manner. Entities estimated to have had less than $8 billion total notional of open IRS swaps on June 5, 2015 were considered not to have material swaps exposure. The Commission understands that it is possible that its estimate of the number of financial end users with material swaps exposure may over- or underestimate the total number of covered counterparties as certain instruments that are used in the calculation are not included in this estimate and certain entities that may be excluded from the Commission's margin rule may be included.

The Commission has estimated this 25% scale factor based on the uncleared outward-facing open interest rate swaps reported to DTCC as of June 5, 2015. The scale factor compares the notional value of swaps covered by the Commission's rule to the total notional value of all swaps reported to the SDR. Because the identity of both counterparties to a trade is relevant for the computation, notional values for each trade side are utilized to construct the ratio (i.e., notional values are double-counted). If both counterparties of a swap are subject to the Commission's margin rule, the notional amount is counted twice (once for each counterparty).If one counterparty is subject to the Commission's margin rule, but the other counterparty is subject to the Prudential Regulators' margin rule, the notional amount is counted once (for the counterparty covered by the Commission's rule).

Based on the SDR data, the Commission estimates that the total notional amount of uncleared interest rate swaps subject to the Commission's initial margin requirement is roughly $42 trillion (where both trade sides are potentially counted). The total notional value, reported to the SDR, used in this calculation is $202 trillion (which is twice the $100.9 trillion, one-sided, total notional value noted earlier). The ratio of these two values is therefore 21% (which equals 42 divided by 202). To be conservative, the Commission assumes that the total notional amount between the CSEs and their covered counterparties account for roughly 25% of the total notional value of uncleared swaps reported to the SDRs.[408]

The net effect of applying these two scale factors to the survey estimates is to multiply the raw, survey estimates of initial margin by approximately 14% (57% x 25% =

[408] The Commission assumed that on June 5, 2015, there were 54 CSEs. The Commission based this number on the number of provisionally registered swap dealers and major swap participants.

14.25%). These estimates are displayed in Table A under the column heading "Covered Swap Entities ($BN)". [409]

Table A presents a range of estimates based on the ISDA and BCBS-IOSCO studies. Both the ISDA's low estimate and the BCBS-IOSCO estimate assume that all initial margin requirements are calculated according to an internal model with parameters consistent with those required by the final rule. The ISDA's high estimate assumes that all initial margin requirements are calculated according to a standardized gross margin approach. Further, the ISDA standardized approach does not allow for the recognition of any netting offsets.[410] The Commission anticipates that most entities will use internal models to calculate initial margin.

Table A.

| Estimated Initial Margin Requirements For Outward Facing Swaps, Based On Prior Estimates Of Global Margin Required | | | |
|---|---|---|---|
| Source | Method | Global ($BN) | Covered Swap Entities* ($BN) |
| ISDA | Standardized | 10,200 | 1,454[411] |
| ISDA | Model Based | 800 | 114[412] |
| BCBS-IOSCO | Model Based | 900 | 128[413] |

[409] The BCBS-IOSCO impact study discusses the impact of several different margin regimes, *e.g.*, regimes with and without an initial margin threshold. In addition, the estimate costs reported in Table A from the BCBS-IOSCO study reflects an estimate from the study that is most comparable to the Commission's final rule.

[410] The ISDA study was conducted based on the BCBS-IOSCO February 2013 consultative document which did not include any recognition of offsets in the standardized initial margin regime. Recognition of offsets was included in the final 2013 international framework.

Applying the standardized approach on SDR data for June 5, 2015, the Commission estimated total gross initial margin due to the new margin requirements at $1.174 trillion for IRS and CDS, which is less than the ISDA-standardized initial margin estimates of $1,454 billion shown in Table A.

[411] 10,200 x 14.25% = 1,454

[412] 800 x 14.25% = 114

* Assumes uncleared swaps between CSEs and their covered counterparties is approximately 14% of global notional outstanding, as described in the text.

Table B presents a matrix of the annual cost estimates associated with the initial margin requirements.[414]

The three rows of the matrix correspond to the ISDA Standardized, ISDA Model Based, and BCBS-IOSCO Model Based approaches for determining initial margin amounts that are presented and discussed above (in relation to Table A). The matrix includes four columns, two of which contain final funding-cost estimates for initial margin required under the final rule. The two funding-cost columns identify the Commission's estimated lower-end and upper-end range for funding costs based on three different methods (i.e., BCBS-IOSCO, ISDA Model Based, and ISDA Standardized).

For the purposes of this matrix, the Commission assumed that the opportunity cost of funding initial margin is between 25 basis points and 160 basis points. The Commission acknowledges that this opportunity cost range is expansive, but based on the Commission's experience and understanding of the entities covered by its margin rule (e.g., swap dealers, insurance companies, collective investment vehicles), it believes that range addresses the idiosyncrasies of these entities. As noted above, some entities covered under the margin rule (e.g., certain registered mutual funds) will be able to post eligible collateral that are already on their balance sheets (i.e., investments). Given this

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[413] 900 x 14.25% = 128

[414] The cost of funding initial margin for CSEs or covered counterparties is a function of the entities' business model, including their financial structure, financial activities and services, and risk profile. The most direct cost of providing initial margin is generally the difference between the cost of funding the required margin, including the opportunity cost on the use of the margin, less the rate of return on the assets used as margin. In some cases, for example, certain registered investment companies will have no additional incremental funding costs, as they will be able to post assets that they currently hold on their balance sheet as eligible collateral. Alternatively, certain entities may have to raise additional funds to purchase eligible assets, as they may not have any or may need more of eligible collateral.

possibility, the Commission makes a conservative assumption that the opportunity cost of pledging collateral on the lower end is 25 basis points.

For the purposes of determining the higher-end of opportunity costs, the Commission accepted Duff & Phelps' weighted average cost of capital of 4.6% for large security brokers and dealers, and then subtracted the 3% return on 30-year Treasury collateral to arrive at 1.6% of funding costs.[415] The Commission assumes that the 160 basis points address situations where, for example, a swap dealer does not have sufficient eligible collateral on its balance sheet. As a result, the swap dealer would need to raise capital by issuing debt or equity to purchase eligible collateral, for instance, 30-year Treasuries to meet the final rule's initial margin requirements. Under this hypothetical, the swap dealer's opportunity costs related to posting eligible collateral are increased.[416]

Each annual funding cost estimate in table B is computed by multiplying the initial margin amount for CSEs (from Table A) identified in each row by the opportunity cost of funding initial margin identified in each column. The amounts presented in Table B are reported in billions.

Table B:

| Estimated Annual Cost of Initial Margin Requirements for- CSEs and Their Covered Counterparties | | | |
|---|---|---|---|
| Source | Method | Final Cost ($BN) | |
| | | Opportunity Cost of Funding Initial Margin (at 0.25%) | Opportunity Cost of Funding Initial Margin (at 1.6%) |

[415] For SIC code 621, Security Brokers, Dealers, Flotation, the Weighted Average Cost of Capital ("WACC") is computed to be 4.6% for large firms as of March 31, 2015 by Duff & Phelps, "2015 Valuation Handbook: Industry Cost of Capital." WACC is estimated over a time horizon that includes a stressed period.

[416] It should be noted that the entity is also forgoing the use of the borrowed funds, as an investment asset. Therefore, this opportunity cost is also imbedded in this cost.

| | | | |
|---|---|---|---|
| ISDA | Standardized | 3.64[417] | 23.26[418] |
| ISDA | Model | 0.29[419] | 1.82[420] |
| BCBS-IOSCO | Model | 0.32[421] | 2.05[422] |

The estimated annual cost of the initial margin requirements depend on the specific initial margin estimate (which depends in large part on whether the standardized or model approach is used) and opportunity cost of funding initial margin. As discussed above, the Commission expects the costs of the final margin rule to be more consistent with the amounts based on the model approach (both ISDA and BCBS-IOSCO), rather than the standardized approach for determining initial margin amounts. Using the estimates based on the model-based approaches, the Commission therefore, expects that the costs of the final rule would most likely range from $290 million to $2.05 billion.

### B. Variation Margin

Under the final rule, the Commission is requiring the daily exchange of variation margin. The requirement is intended to mitigate the build-up of uncollateralized risk at swap counterparties. In requiring the exchange of daily variation margin the Commission acknowledges that there will additional costs to some market participants, particularly to those who are not currently exchanging variation margin daily.[423]

[417] 1,454 x 0.25% = 3.64
[418] 1,454 x 1.6% = 23.26
[419] 114 x 0.25% = 0.29
[420] 114 x 1.6% =1.82
[421] 128 x 0.25% = 0.32
[422] 128 x 1.6% =2.05
[423] As discussed above, it should be noted that the Commission's final rule includes a minimum transfer amount, which is designed to mitigate some of the costs of exchanging variation margin daily.

Presuming that a CSE maintains a relatively flat swap book,[424] the cost of the cash only requirement is small when the CSEs collect enough cash to post to other CSEs.[425] However, when a CSE needs to convert non-cash collaterals collected from financial end users into cash to post to their swap dealer and major swap participant counterparties,[426] it places additional costs on a CSE.[427] In this case, a CSE may use a repurchase agreement to turn non-cash collaterals into cash. The cost of repo transactions depend on many factors, including duration and quality of collateral posted. For example, on September 2, 2015, Bloomberg quotes one week treasury GC repo rate of 0.24%.[428] However, in times of severe financial stress, the repo market may not provide access to market participants. If this happens, a CSE may not be able to turn non-cash collateral into cash which might cause technical defaults. In order to avoid technical defaults, a CSE may elect to pay for a committed repo agreement that gives them the right to enter into a repurchase agreement for a fee at a predetermined repo rate (presumably at a rate significantly above the normal repo rate).[429] This additional cost may be priced into a non-cleared swap agreement and eventually be passed onto financial

[424] The Commission is assuming this as CSEs are dealers and typically do not take proprietary long or short positions, in contrast to other market participants (e.g., hedge funds).
[425] According to the 2015 ISDA Margin Survey, each of the largest dealers receives and pays, on average, roughly 6 billion USD variation margin on a given day. When a swap dealer receives more cash than it needs to pay, or an equal amount, the cost is minimal.
[426] As the final rule requires cash to be posted between a CSE and its swap entity counterparty, while permitting all types of eligible collateral when it transacts with a financial end user, this may result in a collateral mismatch.
[427] For instance, this might happen when a CSE has posted all the non-cash collateral that it can with financial end users as variation margin.
[428] According to the 2015 ISDA Margin Survey, each of the largest dealers receives and pays, on average, roughly 6 billion USD variation margin on a given day. If 1 percent of variation margin received is non-cash collateral which needs to be turned into cash using a repo agreement, then the daily cost will be roughly $400, which is calculated as 60 million x 0.24%/360.
[429] This is similar to a market participant paying a fee to access to a revolving credit facility.

end users who post non-cash collaterals.[430] A CSE might also require financial end users to only post cash, matching it collateral exposure.[431] Despite these possibilities, the Commission notes that most of the variation margin by total volume continues to be in the form of cash exchanged between swap dealers.[432]

The Commission anticipates that many CSEs will have cheaper access to liquidity than most financial end users and may be able to pass along this cost savings to financial end users.[433] The cash only variation margin requirement only holds for swaps between a CSE and another swap entity. The cash only variation margin requirement does not apply to swaps between a CSE and a financial end user. This change from the proposal should provide the flexibility to financial end users to post and to hold the same types of financial instruments in their portfolios for variation margin, as they did prior to the final rule, which should result in less performance drag.[434] Financial end users may still end up paying for the liquidity demanded on CSEs, but, overall, the CSEs' costs are likely to be lower compared to the alternative of requiring cash only variation margin for financial end users, because CSEs may be able to pass on their liquidity advantage to financial end users.

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[430] To the extent that these predetermined repos are used as a funding mechanism for the entire operations of the entity, these costs might not be completely passed on in the price or other aspect of the relationship between the CSE and the financial end user.

[431] It should be noted that this requirement may result in better pricing terms or possibly some other beneficial change in the relationship with the CSE.

[432] According to the 2015 ISDA Margin Survey, 77 percent of variation margin received and 75 percent of variation margin delivered is in the form of cash. Available at https://www2.isda.org/functional-areas/research/surveys/margin-surveys/.

[433] The CSE may be able to pool liquidity needs for end users. Due to CSE liquidity demands, they may need to establish or maintain relationships with banks that have access to cheaper liquidity through the payment system and the Federal Reserve System, in general.

[434] As suggested by NERA, this change should reduce the possibility of pro-cyclicality in time of stress.

## C. Administrative Costs

CSEs and financial end users will face certain startup and ongoing costs relating to technology and other operational infrastructure, as well as new or updated legal agreements. These administrative costs related to margin for uncleared swaps are difficult to quantify at this time; the Commission will discuss these costs qualitatively instead.[435]

The per-entity costs related to changes in technology, infrastructure, and legal agreements are likely to vary widely, depending on each market participant's existing technology infrastructure, legal agreements, and operations, among other things. As discussed in the preamble and below, the Commission expects that certain aspects of the final rule - such as minimum initial margin threshold and expanded list of eligible collaterals - will have mitigating impact on the overall costs to an affected entity. Moreover, the higher degree of harmonization between various regulators and jurisdictions should result in lower administrative costs.[436] Longer lead times for industry to build out compliance systems will lower administrative costs, because it gives industry more time to plan and execute buildouts, which should result in less operational errors and costs.

Examples of the key documents related to administrative costs include: (1) certain self-disclosure documents, (2) credit support annexes; and (3) tri-party segregation of margin collateral that have to be arranged by the parties involved.[437]

[435] In the proposal the Commission requested comments regarding the administrative costs involved in implementing its proposed margin rule; however, the Commission did not receive any quantitative data to assist it in its analysis therefore, the Commission is undertaking a qualitative analysis.
[436] As discussed above, the Commission's final rule is very similar to the Prudential Regulators' final margin rule and the 2013 International Standards.
[437] Costs of these requirements are estimated above in the PRA section.

The Commission expects that counterparties will have to make certain representations regarding their status. These representations will impose certain costs on CSEs and their swap entity and financial end user counterparties. There are at least three types of information when making self-disclosures: (a) jurisdictional information, (b) status information, and (c) initial margin information. Jurisdictional information anticipates possible multi-jurisdictional counterparties. Status information would include, among other information, whether a party is a Commission-registered swap dealer and material swaps exposure information. Initial margin information includes among other information the amount of initial margin for the consolidated group.

There may be multiple credit support annexes between counterparties executing swaps because, among other reasons, the final rule provides for a separate netting treatment of legacy swaps and for calculation of initial margin by netting sets of broad asset classes. Consequently, market participants will need to amend or enter into new credit support agreements to account for the differences from the current arrangement(s), resulting in additional administrative costs.

Tri-party segregation agreements will have to be negotiated as well.[438] These arrangements can be costly as they involve multiple parties and typically customized to the counterparties' needs.[439]

The Commission is aware of certain industry initiatives to standardize documentation in order to create efficiencies and mitigate costs. For example, ISDA plans to implement the following: (1) ISDA Amend Platform, (2) ISDA bookstore for

[438] The Commission notes that some of these agreements will need to be re-negotiated as a result of the final rule.
[439] The final rule's requirements should provide some level of standardization.

Master Agreements and CSAs, and (3) Protocols.[440] The ISDA Amend Platform is technology that would allow swap contracts between counterparties to be standardized, but with customized options to reduce costs.

ISDA is also planning to create a database of standardized Master Agreements and CSAs, updated to reflect the new margin requirements. This initiative should result in more standardized agreements and lower the costs to market participants.

Finally, ISDA is considering developing protocols to facilitate the creation of multilateral agreements based on multiple bilateral agreements. These protocols should provide efficiencies and lower the cost of documentation.

[440] In discussions with ISDA, the Commission understands that these initiatives are currently in progress.

Appendix B

| Seq. | Date Received | Organization |
|---|---|---|
| 1 | 11/11/2014 | Chris Barnard |
| 2 | 11/21/2014 | Japan Financial Markets Council (JFMC) |
| 3 | 11/24/2014 | ICI Global |
| 4 | 11/24/2014 | Investment Company Institute |
| 5 | 11/24/2014 | Committee on Capital Markets Regulation |
| 6 | 11/24/2014 | Structured Finance Industry Group |
| 7 | 11/24/2014 | ISDA (International Swaps and derivatives Association) |
| 8 | 11/24/2014 | Global FX Division (GFXD) of the Global Financial Markets Association (GFMA) |
| 9 | 11/24/2014 | Alberta Investment Mgt Corp; British Columbia Investment Mgt Corp; Caisse de dépôt et placement du Québec; Canada Pension Plan Investment Bd; Healthcare of Ontario Pension Plan Trust Fund; OMERS Administration Corp; Public Sector Pension Investment Bd |
| 10 | 11/24/2014 | American Public Gas Association (APGA) |
| 11 | 11/24/2014 | Securities Industry and Financial Markets Association |
| 12 | 11/24/2014 | State Street Corporation on behalf of itself, Northern Trust Corporation and Bank of New York Mellon Corporation |
| 13 | 11/24/2014 | Metropolitan Life Insurance Company |
| 14 | 11/24/2014 | SIFMA |
| 15 | 11/24/2014 | Skadden, Arps, Slate, Meagher & Flom LLP (on behalf of the Global Pension Coalition) |
| 16 | 11/24/2014 | Institute of International Bankers |
| 17 | 11/24/2014 | TIAA-CREF |
| 18 | 11/25/2014 | Securities Industry and Financial Markets Association (SIFMA) |
| 19 | 11/25/2014 | American Bankers Association (ABA) |
| 20 | 11/25/2014 | Credit Suisse |
| 21 | 11/25/2014 | KfW Bankengruppe |
| 22 | 11/26/2014 | Credit Suisse |
| 23 | 11/27/2014 | Instituto de Crédito Oficial (“ICO”) |
| 24 | 12/2/2014 | Japanese Bankers Association (JBA) |
| 25 | 12/2/2014 | Alternative Investment Management Association (AIMA) |
| 26 | 12/2/2014 | Managed Funds Association |
| 27 | 12/2/2014 | TriOptima |
| 28 | 12/2/2014 | MFX Solutions, Inc. (MFX) |
| 29 | 12/2/2014 | The Financial Services Roundtable |
| 30 | 12/2/2014 | White & Case LLP |
| 31 | 12/2/2014 | FMS Wertmanagement |
| 32 | 12/2/2014 | MasterCard International Incorporated First Data Corporation Vantiv, Inc. |
| 33 | 12/2/2014 | Public Citizen |

| | | |
|---|---|---|
| 34 | 12/2/2014 | American Gas Association American Public Power Association Edison Electric Institute Electric Power Supply Association Large Public Power Council National Rural Electric Cooperative Association |
| 35 | 12/2/2014 | National Corn Growers Association & Natural Gas Supply Association |
| 36 | 12/2/2014 | Freddie Mac |
| 37 | 12/2/2014 | National Rural Utilities Cooperative Finance Corporation |
| 38 | 12/2/2014 | CME Group |
| 39 | 12/2/2014 | Coalition of Physical Energy Companies (COPE) |
| 40 | 12/2/2014 | Sutherland Asbill & Brennan LLP on behalf of the Federal Home Loan Banks |
| 41 | 12/2/2014 | National Economic Research Associates, Inc. |
| 42 | 12/2/2014 | American Council of Life Insurers |
| 43 | 12/2/2014 | International Energy Credit Association |
| 44 | 12/2/2014 | Coalition for Derivatives End users |
| 45 | 12/2/2014 | BP Energy Company |
| 46 | 12/2/2014 | Shell Trading Risk Management |
| 47 | 12/2/2014 | Sutherland Asbill & Brennan LLP on behalf of The Commercial Energy Working Group |
| 48 | 12/2/2014 | Better Markets |
| 49 | 12/9/2014 | Vanguard |
| 50 | 12/2/2014 | National Rural Electric Cooperative Association (NRECA) |
| 51 | 12/2/2014 | Americans for Financial Reform (AFR) |
| 52 | 12/3/2014 | INTL FCStone Inc. |
| 53 | 12/18/2014 | KfW Bankengruppe |
| 54 | 12/11/2014 | Australia and New Zealand Banking Group Commonwealth Bank of Australia Macquarie Bank Ltd National Australia Bank Ltd Westpac Banking Corp |
| 55 | 3/12/2015 | Global Pension Coalition |
| 56 | 5/15/2015 | Managed Funds Association |
| 57 | 6/1/2015 | The Clearing House Association L.L.C. (TCH); American Bankers Association (ABA); ABA Securities Association (ABASA), and the Securities Industry and Financial Markets Association (SIFMA) |
| 58 | 6/9/2015 | William J Harrington |
| 59 | 8/7/2015 | ISDA (International Swaps and derivatives Association) |

List of Subjects

17 CFR Part 23

Swaps, Swap dealers, Major swap participants, Capital and margin requirements.

17 CFR Part 140

Authority delegations (Government agencies), Organization and functions (Government agencies).

For the reasons discussed in the preamble, the Commodity Futures Trading Commission amends 17 CFR chapter I as set forth below:

**PART 23 – SWAP DEALERS AND MAJOR SWAP PARTICIPANTS**

1. The authority citation for part 23 continues to read as follows:

Authority: 7 U.S.C. 1a, 2, 6, 6a, 6b, 6b-1, 6c, 6p, 6r, 6s, 6t, 9, 9a, 12, 12a, 13b, 13c, 16a, 18, 19, 21.

2. Add subpart E to part 23 to read as follows:

**Subpart E – Capital and Margin Requirements for Swap Dealers and Major Swap Participants**

23.162-23.199 [Reserved]

**§§ 23.100 – 23.149 [Reserved]**

**§ 23.150 Scope.**

(a) The margin requirements set forth in § 23.150 through § 23.161 shall apply to uncleared swaps, as defined in § 23.151, that are executed after the applicable compliance dates set forth in § 23.161.

(b) The requirements set forth in § 23.150 through § 23.161 shall not apply to a swap if the counterparty:

(1) Qualifies for an exception from clearing under Section 2(h)(7)(A) of the Act and implementing regulations;

(2) Qualifies for an exemption from clearing under a rule, regulation, or order issued by the Commission pursuant to section 4(c)(1) of the Act concerning cooperative entities that would otherwise be subject to the requirements of section 2(h)(1)(A) of the Act; or

(3) Satisfies the criteria in section 2(h)(7)(D) of the Commodity Exchange Act (7 U.S.C. 2(h)(7)(D)) and implementing regulations.

**§ 23.151 Definitions applicable to margin requirements.**

For the purposes of §§ 23.150 through 23.161:

Bank holding company has the meaning specified in section 2 of the Bank Holding Company Act of 1956 (12 U.S.C. 1841).

Broker has the meaning specified in section 3(a)(4) the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)).

Business day means any day other than a Saturday, Sunday, or legal holiday.

Company means a corporation, partnership, limited liability company, business trust, special purpose entity, association, or similar organization.

Counterparty means the other party to a swap to which a covered swap entity is a party.

Covered counterparty means a financial end user with material swaps exposure or a swap entity that enters into a swap with a covered swap entity.

Covered swap entity means a swap dealer or major swap participant for which there is no prudential regulator.

Cross-currency swap means a swap in which one party exchanges with another party principal and interest rate payments in one currency for principal and interest rate payments in another currency, and the exchange of principal occurs on the date the swap is entered into, with a reversal of the exchange of principal at a later date that is agreed upon when the swap is entered into.

Currency of Settlement means a currency in which a party has agreed to discharge payment obligations related to an uncleared swap or a group of uncleared swaps subject to a master netting agreement at the regularly occurring dates on which such payments are due in the ordinary course.

Day of execution means the calendar day at the time the parties enter into an uncleared swap, provided:

(1) If each party is in a different calendar day at the time the parties enter into the uncleared swap, the day of execution is deemed the latter of the two dates; and

(2) If an uncleared swap is

(i) Entered into after 4:00 p.m. in the location of a party; or

(ii) Entered into on a day that is not a business day in the location of a party, then the uncleared swap is deemed to have been entered into on the immediately succeeding day that is a business day for both parties, and both parties shall determine the day of execution with reference to that business day.

Dealer has the meaning specified in section 3(a)(5) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(5)).

Data source means an entity and/or method from which or by which a covered swap entity obtains prices for swaps or values for other inputs used in a margin calculation.

Depository institution has the meaning specified in section 3(c) of the Federal Deposit Insurance Act (12 U.S.C. 1813(c)).

Eligible collateral means collateral described in § 23.156.

Eligible master netting agreement means a written, legally enforceable agreement provided that:

(1) The agreement creates a single legal obligation for all individual transactions covered by the agreement upon an event of default following any stay permitted by paragraph (2) of this definition, including upon an event of receivership, conservatorship, insolvency, liquidation, or similar proceeding, of the counterparty;

(2) The agreement 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 set off collateral promptly upon an event of default, including upon an event of receivership, conservatorship, insolvency, liquidation, or similar proceeding, of the counterparty, provided that, in any such case, any exercise of rights under the agreement

will not be stayed or avoided under applicable law in the relevant jurisdictions, other than:

(i) In receivership, conservatorship, or resolution under the Federal Deposit Insurance Act (12 U.S.C. 1811 et seq.), Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (12 U.S.C. 5381 et seq), the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, as amended (12 U.S.C. 4617), or the Farm Credit Act of 1971, as amended (12 U.S.C. 2183 and 2279cc), or laws of foreign jurisdictions that are substantially similar to the U.S. laws referenced in this paragraph 2(i) in order to facilitate the orderly resolution of the defaulting counterparty; or

(ii) Where the agreement is subject by its terms to, or incorporates, any of the laws referenced in paragraph 2(i) of this definition;

(3) The agreement does not contain a walkaway clause (that is, a provision that permits a non-defaulting counterparty to make a lower payment than it otherwise would make under the agreement, or no payment at all, to a defaulter or the estate of a defaulter, even if the defaulter or the estate of the defaulter is a net creditor under the agreement); and

(4) A covered swap entity that relies on the agreement for purposes of calculating the margin required by this part must:

(i) Conduct sufficient legal review to conclude with a well-founded basis (and maintain sufficient written documentation of that legal review) that:

(A) The agreement meets the requirements of paragraphs (2) of this definition; and

(B) In the event of a legal challenge (including one resulting from default or from receivership, conservatorship, insolvency, liquidation, or similar proceeding) the relevant court and administrative authorities would find the agreement to be legal, valid, binding, and enforceable under the law of the relevant jurisdictions; and

(ii) Establish and maintain written procedures to monitor possible changes in relevant law and to ensure that the agreement continues to satisfy the requirements of this definition.

Financial end user means

(1) A counterparty that is not a swap entity and that is:

(i) A bank holding company or a margin affiliate thereof; a savings and loan holding company; a U.S. intermediate holding company established or designated for purposes of compliance with 12 CFR 252.153; or a nonbank financial institution supervised by the Board of Governors of the Federal Reserve System under Title I of the Dodd-Frank Wall Street Reform and Consumer Protection Act (12 U.S.C. 5323);

(ii) 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 (12 U.S.C. 1752(1) and (6)); an institution that functions solely in a trust or fiduciary capacity as described in section 2(c)(2)(D) of the Bank Holding Company Act (12 U.S.C. 1841(c)(2)(D)); an industrial loan company, an industrial bank, or other similar institution described in section 2(c)(2)(H) of the Bank Holding Company Act (12 U.S.C. 1841(c)(2)(H));

(iii) 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;

(B) A money services business, including a check casher; money transmitter; currency dealer or exchange; or money order or traveler's check issuer;

(iv) A regulated entity as defined in section 1303(20) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 U.S.C. 4502(20)) or any entity for which the Federal Housing Finance Agency or its successor is the primary federal regulator;

(v) Any institution chartered in accordance with the Farm Credit Act of 1971, as amended, 12 U.S.C. 2001et seq. that is regulated by the Farm Credit Administration;

(vi) A securities holding company; a broker or dealer; an investment adviser as defined in section 202(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)); an investment company registered with the Securities and Exchange Commission under the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.), a company that has elected to be regulated as a business development company pursuant to section 54(a) of the investment Company Act of 1940 915 U.S.C.80a-53(a)) , or a person that is registered with the U.S. Securities and Exchange Commission as a security-based swap dealer or a major security-based swap participant pursuant to the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.).

(vii) A private fund as defined in section 202(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80-b-2(a)); an entity that would be an investment company under section

3 of the Investment Company Act of 1940 (15 U.S.C. 80a-3) 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 of 1940 pursuant to Investment Company Act Rule 3a-7 (17 CFR 270.3a-7) of the Securities and Exchange Commission;

(viii) A commodity pool, a commodity pool operator, a commodity trading advisor, a floor broker, a floor trader, an introducing broker or a futures commission merchant;

(ix) An employee benefit plan as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income and Security Act of 1974 (29 U.S.C. 1002);

(x) 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;

(xi) An entity, person, or arrangement that is, or holds itself out as being, an entity, person, or arrangement that raises money from investors, accepts money from clients, or uses its own money primarily for investing or trading or facilitating the investing or trading in loans, securities, swaps, funds, or other assets; or

(xii) An entity that would be a financial end user described in paragraph (1) of this definition or a swap entity if it were organized under the laws of the United States or any State thereof.

(2) The term "financial end user" does not include any counterparty that is:

(i) A sovereign entity;

(ii) A multilateral development bank;

(iii) The Bank for International Settlements;

(iv) An entity that is exempt from the definition of financial entity pursuant to section 2(h)(7)(C)(iii) of the Act and implementing regulations;

(v) An affiliate that qualifies for the exemption from clearing pursuant to section 2(h)(7)(D) of the Act; or

(vi) An eligible treasury affiliate that the Commission exempts from the requirements of § 23.150 through § 23.161 by rule.

Foreign bank means an organization that is organized under the laws of a foreign country and that engages directly in the business of banking outside the United States.

Foreign exchange forward has the meaning specified in section 1a(24) of the Act

Foreign exchange swap has the meaning specified in section 1a(25) of the Act.

Initial margin means the collateral, as calculated in accordance with 23.154 that is collected or posted in connection with one or more uncleared swaps.

Initial margin model means an internal risk management model that:

(1) Has been developed and designed to identify an appropriate, risk-based amount of initial margin that the covered swap entity must collect with respect to one or more non-cleared swaps to which the covered swap entity is a party; and

(2) Has been approved by the Commission or a registered futures association pursuant to § 23.154(b).

Initial margin threshold amount means an aggregate credit exposure of $50 million resulting from all uncleared swaps between a covered swap entity and its margin affiliates on the one hand, and a covered counterparty and its margin affiliates on the other. For purposes of this calculation, an entity shall not count a swap that is exempt pursuant to § 23.150(b).

Major currencies means

(1) United States Dollar (USD);

(2) Canadian Dollar (CAD);

(3) Euro (EUR);

(4) United Kingdom Pound (GBP);

(5) Japanese Yen (JPY);

(6) Swiss Franc (CHF);

(7) New Zealand Dollar (NZD);

(8) Australian Dollar (AUD);

(9) Swedish Kronor (SEK);

(10) Danish Kroner (DKK);

(11) Norwegian Krone (NOK); and

(12) Any other currency designated by the Commission.

Margin Affiliate A company is a margin affiliate of another company if:

(1) Either company consolidates the other on a financial statement prepared in accordance with U.S. Generally Accepted Accounting Principles, the International Financial Reporting Standards, or other similar standards,

(2) Both companies are consolidated with a third company on a financial statement prepared in accordance with such principles or standards, or

(3) For a company that is not subject to such principles or standards, if consolidation as described in paragraph (1) or (2) would have occurred if such principles or standards had applied,

Market intermediary means

(1) A securities holding company;

(2) A broker or dealer;

(3) A futures commission merchant;

(4) A swap dealer; or

(5) A security-based swap dealer.

Material swaps exposure for an entity means that the entity and its margin affiliates have an average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange forwards, and foreign exchange swaps with all counterparties for June, July and August of the previous calendar year that exceeds $8 billion, where such amount is calculated only for business days. An entity shall count the average daily aggregate notional amount of an uncleared swap, an uncleared security-based swap, a foreign exchange forward, or a foreign exchange swap between the entity and a margin affiliate only one time. For purposes of this calculation, an entity shall not count a swap that is exempt pursuant to § 23.150(b) or a security-based swap that qualifies for an exemption under Section 3C(g)(10) of the Securities Exchange Act of 1934 (15 U.S.C. 78c-3(g)(4) and implementing regulations or that satisfies the criteria in Section 3C(g)(1) of the Securities Exchange Act of 1934 (15 U.S.C. 78-c3(g)(4) and implementing regulations.

Minimum transfer amount means a combined initial and variation margin amount under which no actual transfer of funds is required. The minimum transfer amount shall be $500,000.

Multilateral development bank means

(1) The International Bank for Reconstruction and Development;

(2) The Multilateral Investment Guarantee Agency;

(3) The International Finance Corporation;

(4) The Inter-American Development Bank;

(5) The Asian Development Bank;

(6) The African Development Bank;

(7) The European Bank for Reconstruction and Development;

(8) The European Investment Bank;

(9) The European Investment Fund;

(10) The Nordic Investment Bank;

(11) The Caribbean Development Bank;

(12) The Islamic Development Bank;

(13) The Council of Europe Development Bank; and

(14) Any other entity that provides financing for national or regional development in which the U.S. government is a shareholder or contributing member or which the Commission determines poses comparable credit risk.

Non-financial end user means a counterparty that is not a swap dealer, a major swap participant, or a financial end user.

Prudential regulator has the meaning specified in section 1a(39) of the Act.

Savings and loan holding company has the meaning specified in section 10(n) of the Home Owners' Loan Act (12 U.S.C. 1467a(n)).

Securities holding company has the meaning specified in section 618 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (12 U.S.C. 1850a).

Security-based swap has the meaning specified in section 3(a)(68) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(68)).

Sovereign entity means a central government (including the U.S. government) or an agency, department, ministry, or central bank of a central government.

State means any State, commonwealth, territory, or possession of the United States, the District of Columbia, the Commonwealth of Puerto Rico, the Commonwealth of the Northern Mariana Islands, American Samoa, Guam, or the United States Virgin Islands.

Swap entity means a person that is registered with the Commission as a swap dealer or major swap participant pursuant to the Act.

Uncleared security-based swap means a security-based swap that is not, directly or indirectly, submitted to and cleared by a clearing agency registered with the Securities and Exchange Commission pursuant to section 17A of the Securities Exchange Act of 1934 (15 U.S.C. 78a-1) or by a clearing agency that the U.S. Securities and Exchange Commission has exempted from registration by rule or order pursuant to section 17A of the Securities Exchange Act of 1934 (15 U.S.C. 78a-1).

Uncleared swap means a swap that is not cleared by a registered derivatives clearing organization, or by a clearing organization that the Commission has exempted from registration by rule or order pursuant to section 5b(h) of the Act.

U.S. Government-sponsored enterprise means an entity established or chartered by the U.S. government to serve public purposes specified by federal statute but whose debt obligations are not explicitly guaranteed by the full faith and credit of the U.S. government.

Variation margin means collateral provided by a party to its counterparty to meet the performance of its obligation under one or more uncleared swaps between the parties as a result of a change in value of such obligations since the trade was executed or the last time such collateral was provided.

Variation margin amount means the cumulative mark-to-market change in value to a covered swap entity of an uncleared swap, as measured from the date it is entered into (or in the case of an uncleared swap that has a positive or negative value to a covered swap entity on the date it is entered into, such positive or negative value plus any cumulative mark-to-market change in value to the covered swap entity of an uncleared swap after such date), less the value of all variation margin previously collected, plus the value of all variation margin previously posted with respect to such uncleared swap.

**§ 23.152 Collection and posting of initial margin.**

(a) Collection—(1) Initial obligation. On or before the business day after execution of an uncleared swap between a covered swap entity and a covered counterparty, the covered swap entity shall collect initial margin from the covered counterparty in an amount equal to or greater than an amount calculated pursuant to § 23.154, in a form that complies with § 23.156, and pursuant to custodial arrangements that comply with § 23.157.

(2) Continuing obligation. The covered swap entity shall continue to hold initial margin from the covered counterparty in an amount equal to or greater than an amount calculated each business day pursuant to § 23.154, in a form that complies with § 23.156, and pursuant to custodial arrangements that comply with § 23.157, until such uncleared swap is terminated or expires.

(b) Posting—(1) Initial obligation. On or before the business day after execution of an uncleared swap between a covered swap entity and a financial end user with material swaps exposure, the covered swap entity shall post initial margin with the counterparty in an amount equal to or greater than an amount calculated pursuant to § 23.154, in a form that complies with § 23.156, and pursuant to custodial arrangements that comply with § 23.157.

(2) Continuing obligation. The covered swap entity shall continue to post initial margin with the counterparty in an amount equal to or greater than an amount calculated each business day pursuant to § 23.154, in a form that complies with § 23.156, and pursuant to custodial arrangements that comply with § 23.157, until such uncleared swap is terminated or expires.

(3) Minimum Transfer Amount A covered swap entity is not required to collect or to post initial margin pursuant to § 23.150 through § 23.161 with respect to a particular counterparty unless and until the combined amount of initial margin and variation margin that is required pursuant to § 23.150 through § 23.161 to be collected or posted and that has not been collected or posted with respect to the counterparty is greater than $500,000.

(c) Netting (1) To the extent that one or more uncleared swaps are executed pursuant to an eligible master netting agreement between a covered swap entity and covered counterparty, a covered swap entity may calculate and comply with the applicable initial margin requirements of § 23.150 through § 23.161 on an aggregate net basis with respect to all uncleared swaps governed by such agreement, subject to paragraph (2).

(2)(i) Except as permitted in paragraph (2)(ii), if an eligible master netting agreement covers uncleared swaps entered into on or after the applicable compliance date set forth in § 23.161, all the uncleared swaps covered by that agreement are subject to the requirements of § 23.150 through § 23.161 and included in the aggregate netting portfolio for the purposes of calculating and complying with the margin requirements of § 23.150 through § 23.161.

(ii) An eligible master netting agreement may identify one or more separate netting portfolios that independently meet the requirements in paragraph (1) of the definition of eligible master netting agreement in § 23.151 and to which collection and posting of margin applies on an aggregate net basis separate from and exclusive of any other uncleared swaps covered by the eligible master netting agreement. Any such netting portfolio that contains any uncleared swap entered into on or after the applicable compliance date set forth in § 23.161 is subject to the requirements of § 23.150 through § 23.161. Any such netting portfolio that contains only uncleared swaps entered into before the applicable compliance date is not subject to the requirements of § 23.150 through § 23.161.

(d) Satisfaction of collection and posting requirements. A covered swap entity shall not be deemed to have violated its obligation to collect or to post initial margin from a covered counterparty if:

(1) The covered counterparty has refused or otherwise failed to provide, or to accept, the required initial margin to, or from, the covered swap entity; and

(2) The covered swap entity has:

(i) Made the necessary efforts to collect or to post the required initial margin, including the timely initiation and continued pursuit of formal dispute resolution mechanisms, including pursuant to § 23.504(b)(4), if applicable, or has otherwise demonstrated upon request to the satisfaction of the Commission that it has made appropriate efforts to collect or to post the required initial margin; or

(ii) Commenced termination of the uncleared swap with the covered counterparty promptly following the applicable cure period and notification requirements.

**§ 23.153 Collection and posting of variation margin.**

(a) Initial obligation. On or before the business day after the day of execution of an uncleared swap between a covered swap entity and a counterparty that is a swap entity or a financial end user, the covered swap entity shall collect the variation margin amount from the counterparty when the amount is positive, or post the variation margin amount with the counterparty when the amount is negative as calculated pursuant to § 23.155 and in a form that complies with § 23.156.

(b) Continuing obligation. The covered swap entity shall continue to collect the variation margin amount from, or to post the variation margin amount with, the counterparty as calculated each business day pursuant to § 23.155 and in a form that complies with § 23.156 each business day until such uncleared swap is terminated or expires.

(c) Minimum Transfer Amount A covered swap entity is not required to collect or to post variation margin pursuant to § 23.150 through § 23.161 with respect to a particular counterparty unless and until the combined amount of initial margin and variation margin that is required pursuant to § 23.150 through § 23.161 to be collected or posted and that has not been collected or posted with respect to the counterparty is greater than $500,000.

(d) Netting. (i) To the extent that more than one uncleared swap is executed pursuant to an eligible master netting agreement between a covered swap entity and a counterparty, a covered swap entity may calculate and comply with the applicable variation margin requirements of this section on an aggregate basis with respect to all uncleared swaps governed by such agreement subject to paragraph (2).

(2)(i) Except as permitted in paragraph (2)(ii), if an eligible master netting agreement covers uncleared swaps entered into on or after the applicable compliance date set forth in § 23.161, all the uncleared swaps covered by that agreement are subject to the requirements of § 23.150 through § 23.161 and included in the aggregate netting portfolio for the purposes of calculating and complying with the margin requirements § 23.150 through § 23.161.

(ii) An eligible master netting agreement may identify one or more separate netting portfolios that independently meet the requirements in paragraph (1) of the definition of eligible master netting agreement in § 23.151 and to which collection and posting of margin applies on an aggregate net basis separate from and exclusive of any other uncleared swaps covered by the eligible master netting agreement. Any such netting portfolio that contains any uncleared swap entered into on or after the applicable compliance date set forth in § 23.161 is subject to the requirements of § 23.150 through § 23.161. Any such netting portfolio that contains only uncleared swaps entered into before the applicable compliance date is not subject to the requirements of § 23.150 through § 23.161.

(e) Satisfaction of collection and payment requirements. A covered swap entity shall not be deemed to have violated its obligation to collect or to pay variation margin from a counterparty if:

(1) The counterparty has refused or otherwise failed to provide or to accept the required variation margin to or from the covered swap entity; and

(2) The covered swap entity has:

(i) Made the necessary efforts to collect or to post the required variation margin, including the timely initiation and continued pursuit of formal dispute resolution mechanisms, including pursuant to § 23.504(b)(4), if applicable, or has otherwise demonstrated upon request to the satisfaction of the Commission that it has made appropriate efforts to collect or to post the required variation margin; or

(ii) Commenced termination of the uncleared swap with the counterparty promptly following the applicable cure period and notification requirements.

**§ 23.154 Calculation of initial margin.**

(a) Means of calculation. (1) Each business day each covered swap entity shall calculate an initial margin amount to be collected from each covered counterparty using:

(i) A risk-based model that meets the requirements of paragraph (b) of this section; or

(ii) The table-based method set forth in paragraph (c) of this section.

(2) Each business day each covered swap entity shall calculate an initial margin amount to be posted with each financial end user with material swaps exposure using:

(i) A risk-based model that meets the requirements of paragraph (b) of this section; or

(ii) The table-based method set forth in paragraph (c) of this section.

(3) Each covered swap entity may reduce the amounts calculated pursuant to paragraphs (a)(1) and (2) of this section by the initial margin threshold amount provided that the reduction does not include any portion of the initial margin threshold amount already applied by the covered swap entity or its margin affiliates in connection with other uncleared swaps with the counterparty or its margin affiliates.

(4) The amounts calculated pursuant to paragraph (a)(3) of this section shall not be less than zero.

(b) Risk-based Models—(1) Commission or Registered Futures Association approval. (i) A covered swap entity shall obtain the written approval of the Commission or a registered futures association to use a model to calculate the initial margin required in § 23.150 through § 23.161.

(ii) A covered swap entity shall demonstrate that the model satisfies all of the requirements of this section on an ongoing basis.

(iii) A covered swap entity shall notify the Commission and the registered futures association in writing 60 days prior to:

(A) Extending the use of an initial margin model that has been approved to an additional product type;

(B) Making any change to any initial margin model that has been approved that would result in a material change in the covered swap entity's assessment of initial margin requirements; or

(C) Making any material change to modeling assumptions used by the initial margin model.

(iv) The Commission or the registered futures association may rescind approval of the use of any initial margin model, in whole or in part, or may impose additional conditions or requirements if the Commission or the registered futures association determines, in its discretion, that the model no longer complies with this section.

(2) Elements of the model. (i) The initial margin model shall calculate an amount of initial margin that is equal to the potential future exposure of the uncleared swap or netting portfolio of uncleared swaps covered by an eligible master netting agreement. Potential future exposure is an estimate of the one-tailed 99 percent confidence interval for an increase in the value of the uncleared swap or netting portfolio of uncleared swaps 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 ten business days or the maturity of the swap or netting portfolio.

(ii) All data used to calibrate the initial margin model shall be based on an equally weighted historical observation period of at least one year and not more than five years and must incorporate a period of significant financial stress for each broad asset class that is appropriate to the uncleared swaps to which the initial margin model is applied.

(iii) The initial margin model shall use risk factors sufficient to measure all material price risks inherent in the transactions for which initial margin is being calculated. The risk categories shall include, but should not be limited to, foreign exchange or interest rate risk, credit risk, equity risk, and commodity risk, as appropriate. For material exposures in significant currencies and markets, modeling techniques shall capture spread and basis risk and shall incorporate a sufficient number of segments of the yield curve to capture differences in volatility and imperfect correlation of rates along the yield curve.

(iv) In the case of an uncleared cross-currency swap, the initial margin 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 uncleared cross-currency swap. The initial margin model must recognize all material risks and risk factors associated with all other payments and cash flows that occur during the life of the uncleared cross-currency swap.

(v) The initial margin model may calculate initial margin for an uncleared swap or netting portfolio of uncleared swaps covered by an eligible master netting agreement. It may reflect offsetting exposures, diversification, and other hedging benefits for uncleared swaps that are governed by the same eligible master netting agreement by incorporating empirical correlations within the following broad risk categories, provided the covered swap entity validates and demonstrates the reasonableness of its process for modeling and measuring hedging benefits: commodity, credit, equity, and foreign exchange or interest rate. Empirical correlations under an eligible master netting agreement may be recognized by the model within each broad risk category, but not across broad risk categories.

(vi) If the initial margin model does not explicitly reflect offsetting exposures, diversification, and hedging benefits between subsets of uncleared swaps within a broad risk category, the covered swap entity shall calculate an amount of initial margin separately for each subset of uncleared swaps for which such relationships are explicitly recognized by the model. The sum of the initial margin amounts calculated for each subset of uncleared swaps within a broad risk category will be used to determine the aggregate initial margin due from the counterparty for the portfolio of uncleared swaps within the broad risk category.

(vii) The sum of the initial margin calculated for each broad risk category shall be used to determine the aggregate initial margin due from the counterparty.

(viii) The initial margin model shall not permit the calculation of any initial margin 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 the counterparty.

(ix) The initial margin model shall include all material risks arising from the nonlinear price characteristics of option positions or positions with embedded optionality and the sensitivity of the market value of the positions to changes in the volatility of the underlying rates, prices, or other material risk factors.

(x) The covered swap entity shall not omit any risk factor from the calculation of its initial margin that the covered swap entity uses in its model unless it has first demonstrated to the satisfaction of the Commission or the registered futures association that such omission is appropriate.

(xi) The covered swap entity shall not incorporate any proxy or approximation used to capture the risks of the covered swap entity's uncleared swaps unless it has first demonstrated to the satisfaction of the Commission or the registered futures association that such proxy or approximation is appropriate.

(xii) The covered swap entity shall have a rigorous and well-defined process for re-estimating, re-evaluating, and updating its internal margin models to ensure continued applicability and relevance.

(xiii) The covered swap entity shall review and, as necessary, revise the data used to calibrate the initial margin model at least annually, and more frequently as market conditions warrant, to ensure that the data incorporate a period of significant financial stress appropriate to the uncleared swaps to which the initial margin model is applied.

(xiv) The level of sophistication of the initial margin model shall be commensurate with the complexity of the swaps to which it is applied. In calculating an initial margin amount, the initial margin model may make use of any of the generally accepted approaches for modeling the risk of a single instrument or portfolio of instruments.

(xv) The Commission or the registered futures association may in its discretion require a covered swap entity using an initial margin model to collect a greater amount of initial margin than that determined by the covered swap entity's initial margin model if the Commission or the registered futures association determines that the additional collateral is appropriate due to the nature, structure, or characteristics of the covered swap entity's transaction(s) or is commensurate with the risks associated with the transaction(s).

(4) Periodic review. A covered swap entity shall periodically, but no less frequently than annually, review its initial margin model in light of developments in financial markets and modeling technologies, and enhance the initial margin model as appropriate to ensure that it continues to meet the requirements for approval in this section.

(5) Control, oversight, and validation mechanisms. (i) The covered swap entity shall maintain a risk management unit in accordance with § 23.600(c)(4)(i) that is independent from the business trading unit (as defined in § 23.600).

(ii) The covered swap entity's risk control unit shall validate its initial margin model prior to implementation and on an ongoing basis. The covered swap entity's validation process shall be independent of the development, implementation, and operation of the initial margin model, or the validation process shall be subject to an independent review of its adequacy and effectiveness. The validation process shall include:

(A) An evaluation of the conceptual soundness of (including developmental evidence supporting) the initial margin model;

(B) An ongoing monitoring process that includes verification of processes and benchmarking by comparing the covered swap entity's initial margin model outputs (estimation of initial margin) with relevant alternative internal and external data sources or estimation techniques. The benchmark(s) must address the model's limitations. When applicable the covered swap entity should consider benchmarks that allow for non-normal distributions such as historical and Monte Carlo simulations. When applicable validation shall include benchmarking against observable margin standards to ensure that the initial margin required is not less than what a derivatives clearing organization would require for similar cleared transactions; and

(C) An outcomes analysis process that includes back testing the model. This analysis shall recognize and compensate for the challenges inherent in back testing over periods that do not contain significant financial stress.

(iii) If the validation process reveals any material problems with the model, the covered swap entity must promptly notify the Commission and the registered futures association of the problems, describe to the Commission and the registered futures association any remedial actions being taken, and adjust the model to ensure an appropriately conservative amount of required initial margin is being calculated.

(iv) In accordance with §23.600(e)(2), the covered swap entity shall have an internal audit function independent of the business trading unit and the risk management unit that at least annually assesses the effectiveness of the controls supporting the initial margin model measurement systems, including the activities of the business trading units and risk control unit, compliance with policies and procedures, and calculation of the covered swap entity's initial margin requirements under this part. At least annually, the internal audit function shall report its findings to the covered swap entity's governing body, senior management, and chief compliance officer.

(6) Documentation. The covered swap entity shall adequately document all material aspects of its model, including management and valuation of uncleared swaps to which it applies, the control, oversight, and validation of the initial margin model, any review processes and the results of such processes.

(7) Escalation procedures. The covered swap entity must adequately document (i) internal authorization procedures, including escalation procedures, that require review and approval of any change to the initial margin calculation under the initial margin model, (ii) demonstrable analysis that any basis for any such change is consistent with the requirements of this section, and (iii) independent review of such demonstrable analysis and approval.

(c) Table-based method. If a model meeting the standards set forth in paragraph (b) of this section is not used, initial margin shall be calculated in accordance with this paragraph.

(1) Standardized initial margin schedule.

| **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 |

(2) Net to gross ratio adjustment. (i) For multiple uncleared swaps subject to an eligible master netting agreement, the initial margin amount under the standardized table shall be computed according to this paragraph.

(ii) Initial Margin = 0.4 x Gross Initial Margin + 0.6x Net-to-Gross Ratio x Gross Initial Margin, where

(A) Gross Initial Margin = the sum of the product of each uncleared swap's effective notional amount and the gross initial margin requirement for all uncleared swaps subject to the eligible master netting agreement;

(B) Net-to-Gross Ratio = the ratio of the net current replacement cost to the gross current replacement cost;

(C) Gross Current Replacement cost = the sum of the replacement cost for each uncleared swap subject to the eligible master netting agreement for which the cost is positive; and

(D) Net Current Replacement Cost = the total replacement cost for all uncleared swaps subject to the eligible master netting agreement.

(E) In cases where the gross replacement cost is zero, the Net-to-Gross Ratio shall be set to 1.0.

**§ 23.155 Calculation of variation margin.**

(a) Means of calculation. (1) Each business day each covered swap entity shall calculate variation margin for itself and for each counterparty that is a swap entity or a financial end user using methods, procedures, rules, and inputs that to the maximum extent practicable rely on recently-executed transactions, valuations provided by independent third parties, or other objective criteria.

(2) Each covered swap entity shall have in place alternative methods for determining the value of an uncleared swap in the event of the unavailability or other failure of any input required to value a swap.

(b) Control mechanisms. (1) Each covered swap entity shall create and maintain documentation setting forth the variation methodology with sufficient specificity to allow the counterparty, the Commission, the registered futures association, and any applicable prudential regulator to calculate a reasonable approximation of the margin requirement independently.

(2) Each covered swap entity shall evaluate the reliability of its data sources at least annually, and make adjustments, as appropriate.

(3) The Commission or the registered futures association at any time may require a covered swap entity to provide further data or analysis concerning the methodology or a data source, including:

(i) An explanation of the manner in which the methodology meets the requirements of this section;

(ii) A description of the mechanics of the methodology;

(iii) The conceptual basis of the methodology;

(iv) The empirical support for the methodology; and

(v) The empirical support for the assessment of the data sources.

**§ 23.156 Forms of margin.**

(a) Initial margin—(1) Eligible collateral. A covered swap entity shall collect and post as initial margin for trades with a covered counterparty only the following types of collateral:

(i) Immediately available cash funds denominated in:

(A) U.S. dollars;

(B) A major currency;

(C) A currency of settlement for the uncleared swap;

(ii) A security that is issued by, or unconditionally guaranteed as to the timely payment of principal and interest by, the U.S. Department of Treasury;

(iii) A security that is issued by, or unconditionally guaranteed as to the timely payment of principal and interest by, a U.S. government agency (other than the U.S. Department of Treasury) whose obligations are fully guaranteed by the full faith and credit of the U.S. government;

(iv) A security that is issued by, or fully guaranteed as to the payment of principal and interest 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 swap dealers subject to regulation by a prudential regulator;

(v) A publicly traded debt security issued by, or an asset-backed security fully guaranteed as to the timely payment of principal and interest by, a U.S. Government-sponsored enterprise that is operating with capital support or another form of direct financial assistance received from the U.S. government that enables the repayments of the U.S. Government-sponsored enterprise's eligible securities;

(vi) A security that is issued by, or fully guaranteed as to the payment of principal and interest by, the Bank for International Settlements, the International Monetary Fund, or a multilateral development bank;

(vii) Other publicly-traded debt that has been deemed acceptable as initial margin by a prudential regulator;

(viii) A publicly traded common equity security that is included in:

(A) The Standard & Poor's Composite 1500 Index or any other similar index of liquid and readily marketable equity securities as determined by the Commission; or

(B) An index that a covered swap entity's supervisor in a foreign jurisdiction recognizes for purposes of including publicly traded common equity as initial margin under applicable regulatory policy, if held in that foreign jurisdiction;

(ix) Securities in the form of redeemable securities in a pooled investment fund representing the security-holder's proportional interest in the fund's net assets and that are issued and redeemed only on the basis of the market value of the fund's net assets prepared each business day after the security-holder makes its investment commitment or redemption request to the fund, if the fund's investments are limited to the following:

(A) Securities that are issued by, or unconditionally guaranteed as to the timely payment of principal and interest by, the U.S. Department of the Treasury, and immediately-available cash funds denominated in U.S. dollars; or

(B) Securities denominated in a common currency and issued by, or fully guaranteed as to the payment of principal and interest 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 swap dealers subject to regulation by a prudential regulator, and immediately-available cash funds denominated in the same currency; and

(C) Assets of the fund may not be transferred through securities lending, securities borrowing, repurchase agreements, reverse repurchase agreements, or other means that involve the fund having rights to acquire the same or similar assets from the transferee, or

(x) Gold.

(2) Prohibition of certain assets. A covered swap entity may not collect or post as initial margin any asset that is a security issued by:

(i) The covered swap entity or a margin affiliate of the covered swap entity (in the case of posting) or the counterparty or any margin affiliate of the counterparty (in the case of collection),

(ii) A bank holding company, a savings and loan holding company, a U.S. intermediate holding company established or designated for purposes of compliance with 12 C.F.R. 252.153, a foreign bank, a depository institution, a market intermediary, a company that would be any of the foregoing if it were organized under the laws of the United States or any State, or a margin affiliate of any of the foregoing institutions, or

(iii) A nonbank financial institution supervised by the Board of Governors of the Federal Reserve System under Title I of the Dodd-Frank Wall Street Reform and Consumer Protection Act ( 12 U.S.C. 5323).

(3)Haircuts. (i) The value of any eligible collateral collected or posted to satisfy initial margin requirements shall be subject to the sum of the following discounts, as applicable:

(A) An 8 percent discount for initial margin collateral denominated in a currency that is not the currency of settlement for the uncleared swap, except for eligible types of collateral denominated in a single termination currency designated as payable to the non-posting counterparty as part of the eligible master netting agreement; and

(B) The discounts set forth in the following table:

Standardized Haircut Schedule

| | |
|---|---|
| Cash in same currency as swap obligation | 0.0 |
| Eligible government and related debt (e.g., central bank, multilateral development bank, GSE securities identified in paragraph (a)(1)(iv) of this section): | 0.5 |

| | |
|---|---|
| residual maturity less than one-year | |
| Eligible government and related debt (e.g., central bank, multilateral development bank, GSE securities identified in paragraph (a)(1)(iv) of this section): residual maturity between one and five years | 2.0 |
| Eligible government and related debt (e.g., central bank, multilateral development bank, GSE securities identified in paragraph (a)(1)(iv) of this section): residual maturity greater than five years | 4.0 |
| Eligible corporate debt (including eligible GSE debt securities not identified in paragraph (a)(1)(iv) of this section): residual maturity less than one-year | 1.0 |
| Eligible corporate debt (including eligible GSE debt securities not identified in paragraph (a)(1)(iv) of this section): residual maturity between one and five years | 4.0 |
| Eligible corporate debt (including eligible GSE debt securities not identified in paragraph (a)(1)(iv) of this section): residual maturity greater than five years | 8.0 |
| Equities included in S&P 500 or related index | 15.0 |
| 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 |

(ii) The value of initial margin collateral shall be computed as the product of the cash or market value of the eligible collateral asset times one minus the applicable haircut expressed in percentage terms. The total value of all initial margin collateral is calculated as the sum of those values for each eligible collateral asset.

(b) Variation margin (1) Eligible collateral.

(i) Swaps with a swap entity

(A) A covered swap entity shall post and collect as variation margin to or from a counterparty that is a swap entity only immediately available cash funds that are denominated in :U.S. dollars;

(B) Another major currency; or

(C) The currency of settlement of the uncleared swap.

(ii) Swaps with a financial end user

A covered swap entity may post and collect as variation margin to or from a counterparty that is a financial end user any asset that is eligible to be posted or collected as initial margin under paragraphs (a)(1) and (a)(2) of this section.

(2) Haircuts (i) The value of any eligible collateral collected or posted to satisfy variation margin requirements shall be subject to the sum of the following discounts, as applicable:

(A) An 8% discount for variation margin collateral denominated in a currency that is not the currency of settlement for the uncleared swap except for immediately available cash funds denominated in U.S. cash funds or another major currency; and

(B)The discounts for initial margin set forth in the table in paragraph (a)(3)(i)(B)

(ii)The value of variation margin collateral shall be computed as the product of the cash or market value of the eligible collateral asset times one minus the applicable haircut expressed in percentage terms. The total value of all variation margin collateral shall be calculated as the sum of those values of each eligible collateral asset.

(c) Monitoring Obligation. A covered swap entity shall monitor the market value and eligibility of all collateral collected and posted to satisfy the margin requirements of § 23.150 through § 23.161. To the extent that the market value of such collateral has declined, the covered swap entity shall promptly collect or post such additional eligible collateral as is necessary to maintain compliance with the margin requirements of § 23.150 through § 23.161. To the extent that the collateral is no longer eligible, the covered swap entity shall promptly collect or post sufficient eligible replacement collateral to comply with the margin requirements of § 23.150 through § 23.161.

(d) Excess margin. A covered swap entity may collect or post initial margin or variation margin that is not required pursuant to § 23.150 through § 23.161 in any form of collateral.

**§ 23.157 Custodial arrangements.**

(a) Initial margin posted by covered swap entities. Each covered swap entity that posts initial margin with respect to an uncleared swap shall require that all funds or other property that the covered swap entity provides as initial margin be held by one or more custodians that are not the covered swap entity, the counterparty, or margin affiliates of the covered swap entity or the counterparty.

(b) Initial margin collected by covered swap entities. Each covered swap entity that collects initial margin required by § 23.152 with respect to an uncleared swap shall require that such initial margin be held by one or more custodians that are not the covered swap entity, the counterparty, or margin affiliates of the covered swap entity or the counterparty.

(c) Custodial agreement. Each covered swap entity shall enter into an agreement with each custodian that holds funds pursuant to paragraphs (a) or (b) of this section that:

(1) Prohibits the custodian from rehypothecating, repledging, reusing, or otherwise transferring (through securities lending, securities borrowing, repurchase agreement, reverse repurchase agreement or other means) the collateral held by the custodian except that cash collateral may be held in a general deposit account with the custodian if the funds in the account are used to purchase an asset described in § 23.156(a)(1)(iv) –(xii), such asset is held in compliance with this section, and such purchase takes place within a time period reasonably necessary to consummate such purchase after the cash collateral is posted as initial margin; and

(2) Is a legal, valid, binding, and enforceable agreement under the laws of all relevant jurisdictions including in the event of bankruptcy, insolvency, or a similar proceeding.

(3) Notwithstanding paragraph (c)(1) of this section, a custody agreement may permit the posting party to substitute or direct any reinvestment of posted collateral held by the custodian, provided that, with respect to collateral posted or collected pursuant to § 23.152, the agreement requires the posting party, when it substitutes or directs the reinvestment of posted collateral held by the custodian.

(i) To substitute only funds or other property that would qualify as eligible collateral under § 23.156, and for which the amount net of applicable discounts described in § 23.156 would be sufficient to meet the requirements of § 23.152; and

(ii) To direct reinvestment of funds only in assets that would qualify as eligible collateral under § 23.156, and for which the amount net of applicable discounts described in § 23.156 would be sufficient to meet the requirements of § 23.152;

**§ 23.158 Margin documentation.**

(a) General requirement. Each covered swap entity shall execute documentation with each counterparty that complies with the requirements of § 23.504 and that complies with this section, as applicable. For uncleared swaps between a covered swap entity and a counterparty that is a swap entity or a financial end user, the documentation shall provide the covered swap entity with the contractual right and obligation to exchange initial margin and variation margin in such amounts, in such form, and under such circumstances as are required by §§ 23.150 through 23.161.

(b) Contents of the documentation. The margin documentation shall:

(1) Specify the methods, procedures, rules, inputs, and data sources to be used for determining the value of uncleared swaps for purposes of calculating variation margin;

(2) Describe the methods, procedures, rules, inputs, and data sources to be used to calculate initial margin for uncleared swaps entered into between the covered swap entity and the counterparty; and

(3) Specify the procedures by which any disputes concerning the valuation of uncleared swaps, or the valuation of assets collected or posted as initial margin or variation margin may be resolved.

**§ 23.159 Special rules for affiliates**

(a) Initial Margin

(1) Except as provided in paragraph (c) of this section, a covered swap entity shall not be required to collect initial margin from a margin affiliate provided that the covered swap entity meets the following conditions:

(i) The swaps are subject to a centralized risk management program that is reasonably designed to monitor and to manage the risks associated with the inter-affiliate swaps; and

(ii) The covered swap entity exchanges variation margin with the margin affiliate in accordance with paragraph (b) of this section.

(2) (i) A covered swap entity shall post initial margin to any margin affiliate that is a swap entity subject to the rules of a Prudential Regulator in an amount equal to the amount that the swap entity is required to collect from the covered swap entity pursuant to the rules of the Prudential Regulator.

(ii) A covered swap entity shall not be required to post initial margin to any other margin affiliate pursuant to §§ 23.150 through 23.161.

(b) <u>Variation margin</u>

Each covered swap entity shall post and collect variation margin with each margin affiliate that is a swap entity or a financial end user in accordance with all applicable provisions of §§ 23.150 through 23.161.

<u>(c) Foreign margin affiliates</u>

(1) For purposes of this section, the term outward facing margin affiliate means a margin affiliate that enters into swaps with third parties.

(2) Except as provided in paragraph (c)(3), each covered swap entity shall collect initial margin in accordance with all applicable provisions of §§ 23.150 through 23.161 from each margin affiliate that meets the following criteria:

(i) The margin affiliate is a financial end user;

(ii) The margin affiliate enters into swaps with third parties, or enters into swaps with any other margin affiliate that, directly or indirectly (including through a series of transactions), enters into swaps with third parties, for which the provisions of §§ 23.150 through 23.161 would apply if any such margin affiliate were a swap entity; and

(iii) Any such outward facing margin affiliate is located in a jurisdiction that the Commission has not found to be eligible for substituted compliance with regard to the provisions of §§ 23.150 through 23.161and does not collect initial margin for such swaps in a manner that would comply with the provisions of §§ 23.150 through 23.161.

(3) The custodian for initial margin collected pursuant to paragraph (1) may be the covered swap entity or a margin affiliate of the covered swap entity.

**§ 23.160 [Reserved]**

**§ 23.161 Compliance dates.**

(a) Covered swap entities shall comply with the minimum margin requirements for uncleared swaps on or before the following dates for uncleared swaps entered into on or after the following dates:

(1) September 1, 2016 for the requirements in § 23.152 for initial margin and in § 23.153 for variation margin for any uncleared swaps where both

(i) the covered swap entity combined with all its margin affiliates; and

(ii) its counterparty combined with all its margin affiliates, have an average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange forwards, and foreign exchange swaps in March, April, and May 2016 that exceeds $3 trillion, where such amounts are calculated only for business days; and where

(iii) in calculating the amounts in paragraphs (a)(1)(i) and (a)(1) (ii), an entity shall count the average daily notional amount of an uncleared swap, an uncleared security-based swap, a foreign-exchange forward, or a foreign exchange swap between an entity or a margin affiliate only one time and shall not count a swap or a security-based swap that is exempt pursuant to § 23.150(b) or a security-based swap that is exempt pursuant to section 15F(e) of the Securities Exchange Act of 1934 (15 U.S.C. 78o-10(e)).

(2) March 1, 2017 for the requirements in § 23.153 for variation margin for any other covered swap entity for uncleared swaps entered into with any other counterparty.

(3) September 1, 2017 for the requirements in § 23.152 for initial margin for any uncleared swaps where both

(i) the covered swap entity combined with all its margin affiliates; and

(ii) its counterparty combined with all its margin affiliates, have an average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange forwards, and foreign exchange swaps in March, April, and May 2017 that exceeds $2.25 trillion, where such amounts are calculated only for business days; and where

(iii) in calculating the amounts in paragraphs (a)(3)(i) and (a)(3) (ii), an entity shall count the average daily notional amount of an uncleared swap, an uncleared security-based swap, a foreign-exchange forward, or a foreign exchange swap between an entity or a margin affiliate only one time and shall not count a swap or a security-based swap that is exempt pursuant to § 23.150(b) or a security-based swap that is exempt pursuant to section 15F(e) of the Securities Exchange Act of 1934 (15 U.S.C. 78o-10(e)).

(4) September 1, 2018, for the requirements in § 23.152 for initial margin for any uncleared swaps where both

(i) the covered swap entity combined with all its margin affiliates; and

(ii) its counterparty combined with all its margin affiliates have an average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange forwards, and foreign exchange swaps in March, April, and May 2018 that exceeds $1.5 trillion, where such amounts are calculated only for business days; and where

(iii) in calculating the amounts in paragraphs (a)(4)(i) and (a)(4) (ii), an entity shall count the average daily notional amount of an uncleared swap, an uncleared security-based swap, a foreign-exchange forward, or a foreign exchange swap between an entity or a margin affiliate only one time and shall not count a swap or a security-based swap that is exempt pursuant to § 23.150(b) or a security-based swap that is exempt pursuant to section 15F(e) of the Securities Exchange Act of 1934 (15 U.S.C. 78o-10(e)).

(5) September 1, 2019 for the requirements in § 23.152 for initial margin for any uncleared swaps where both

(i) the covered swap entity combined with all its margin affiliates; and

(ii) its counterparty combined with all its margin affiliates have an average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange forwards, and foreign exchange swaps in March, April, and May 2019 that exceeds $0.75 trillion, where such amounts are calculated only for business days; and where

(iii) in calculating the amounts in paragraphs (a)(5)(i) and (a)(5) (ii), an entity shall count the average daily notional amount of an uncleared swap, an uncleared security-based swap, a foreign-exchange forward, or a foreign exchange swap between an entity or a margin affiliate only one time and shall not count a swap or a security-based swap that is exempt pursuant to § 23.150(b) or a security-based swap that is exempt pursuant to section 15F(e) of the Securities Exchange Act of 1934 (15 U.S.C. 78o-10(e)).

(6) September 1, 2020 for the requirements in § 23.152 for initial margin for any other covered swap entity with respect to uncleared swaps entered into with any other counterparty.

(b) Once a covered swap entity and its counterparty must comply with the margin requirements for uncleared swaps based on the compliance dates in paragraph (a) of this section, the covered swap entity and its counterparty shall remain subject to the requirements of § 23.150 through § 23.161 with respect to that counterparty.

(c) (1) If a covered swap entity's counterparty changes its status such that an uncleared swap with that counterparty becomes subject to a stricter margin requirement under § 23.150 through § 23.161 (for example, if the counterparty's status changes from a financial end user without material swaps exposure to a financial end user with material swaps exposure), then the covered swap entity shall comply with the stricter margin requirements for any uncleared swaps entered into with that counterparty after the counterparty changes its status.

(2) If a covered swap entity's counterparty changes its status such that an uncleared swap with that counterparty becomes subject to less strict margin requirement under § 23.150 through § 23.161 (for example, if the counterparty's status changes from a financial end user with material swaps exposure to a financial end user without material swaps exposure), then the covered swap entity may comply with the less strict margin requirements for any uncleared swaps entered into with that counterparty after the counterparty changes its status as well as for any outstanding uncleared swap entered into after the applicable compliance date under paragraph (a) of this section and before the counterparty changed its status.

**§§ 23.162 – 23.199 [Reserved]**

3. In § 23.701 revise paragraphs (a)(1), (d), and (f) to read as follows:

**§ 23.701 Notification of right to segregation.**

(a) * * *

(1) Notify each counterparty to such transaction that the counterparty has the right to require that any Initial Margin the counterparty provides in connection with such transaction be segregated in accordance with §§ 23.702 and 23.703 except in those circumstances where segregation is mandatory pursuant to § 23.157;

* * * * *

(d) Prior to confirming the terms of any such swap, the swap dealer or major swap participant shall obtain from the counterparty confirmation of receipt by the person specified in paragraph (c) of this section of the notification specified in paragraph (a) of this section, and an election, if applicable, to require such segregation or not. The swap dealer or major swap participant shall maintain such confirmation and such election as business records pursuant to § 1.31 of this chapter.

* * * * *

(f) A counterparty's election, if applicable, to require segregation of Initial Margin or not to require such segregation, may be changed at the discretion of the counterparty upon written notice delivered to the swap dealer or major swap participant, which changed election shall be applicable to all swaps entered into between the parties after such delivery.

**PART 140 – ORGANIZATION, FUNCTIONS, AND PROCEDURES OF THE COMMISSION**

4. The authority citation for part 140 continues to read as follows:

Authority: 7 U.S.C. 2(a)(12), 12a, 13(c), 13(d), 13(e), and 16(b).

5. In § 140.93, add paragraph (a)(6) to read as follows:

**§ 140.93 Delegation of authority to the Director of the Division of Swap Dealer and Intermediary Oversight.**

(a) * * *

(6) All functions reserved to the Commission in §§ 23.150 through 23.161 of this chapter.

* * * * *

Issued in Washington, DC, on December __, 2015, by the Commission.

Christopher J. Kirkpatrick,

Secretary of the Commission.

NOTE: The following appendices will not appear in the Code of Federal Regulations.

**Appendices to Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants – Commission Voting Summary, Chairman's Statement, and Commissioners' Statements**

**Appendix 1 – Commission Voting Summary**

On this matter, Chairman Massad and Commissioner Giancarlo voted in the affirmative. Commissioner Bowen voted in the negative.

**Appendix 2 – Statement of Chairman Timothy G. Massad**

The rule this Commission is adopting today is one of the most important elements of swaps market regulation set forth in the Dodd-Frank Act. Although we have mandated clearing for standardized swaps, there will always be a large part of the market that is not cleared. This is entirely appropriate, as many swaps are not suitable for central clearing because of limited liquidity or other characteristics. Our clearinghouses will be stronger if we exercise care in what is required to be cleared. However, we must take steps to protect against such activity posing excessive risk to the system. That is why margin requirements for uncleared swaps are important.

The rule we are adopting today is strong and sensible. It requires swap dealers and major swap participants ("covered swap entities" or "CSEs") to post and collect margin with financial entities with whom they have significant exposures. It requires initial margin, which is designed to protect against potential future loss on a default, as well as variation margin, which serves as mark-to-market protection. It allows for the use of a broad range of types of collateral, but only with appropriate haircuts. It requires a greater level of margin than for cleared swaps, given that uncleared swaps are likely to be less liquid. It requires segregation of margin with third party custodians, and prohibits rehypothecation.

While there are costs to this rule, they are justified in light of the potential risks that uncleared swaps can pose. We learned this firsthand in the global financial crisis, which resulted in dramatic suffering and loss for American families.

The swap activities of commercial end-users were not a source of significant risk in the financial crisis, and we must make sure that they can continue using the derivatives markets effectively and efficiently. Accordingly, an important feature of our rule is that these margin requirements do not apply to swaps with commercial end-users. This was an element of our proposed rule and is in accordance with the intent of Congress. Instead, our rule focuses on those entities that create the greatest risks to our system through uncleared swaps: the large financial institutions with the greatest amount of swap activity.

Our rule is practically identical to the rules of the United States banking regulators, and substantially similar to international rules. Harmonization is critical to creating a sound international framework for regulation. Shortly after I took office, I committed to doing all we could to achieve such harmonization, and we have succeeded. For example, a year ago there were significant differences between proposals by the CFTC as well as the prudential regulators on the one hand, and international regulators on the other. But today, all these rules are substantially similar. This is true with respect to a number of provisions, including a two-way "post and collect" obligation; the material swaps threshold that determines when the requirements apply; the minimum transfer amount; the types of permissible collateral; the haircuts used in valuing types of collateral; the general provisions on models for calculating margin; segregation requirements; and the use of different currencies for collateral. We have also taken into account concerns related to the timing of when margin must be posted and made changes to address the complexities of cross-border transactions.

Today's rule is designed to address the potential risks that can arise if a CSE or large financial entity defaults on transactions with another CSE or large financial entity. We are particularly seeking to reduce the risk that such a default leads to further defaults by those counterparties, given the interconnectedness of our financial system. We became all too familiar with that risk in 2008. Margin is designed to reduce the risk of cascading defaults by enabling the non-defaulting party to recover its loss. Some will characterize this as expensive insurance, as both parties must post initial margin as protection against potential future loss, even though in default, only one would actually recover against the margin. But we need only remember the costs of the crisis to our economy to recognize that this is, on the contrary, quite sensible.

The issue of how our rule should apply to inter-affiliate transactions has received a lot of attention. I believe we should look at this issue in terms of the goals of the rule, which are first and foremost to avoid the potential for the buildup of excessive risk from bilateral transactions between unaffiliated parties. Inter-affiliate transactions are not outward-facing and thus do not increase the overall risk exposure of the consolidated enterprise to third parties. Instead, they are typically a means for the consolidated enterprise to centrally manage risk related to the activities of multiple subsidiaries. Imposing the same third-party transaction standards on these internal activities of consolidated entities is likely to significantly increase costs to end-users without any commensurate benefit. Nevertheless, we have imposed some protections and requirements.

First, we must make sure that inter-affiliate transactions are not used as a loophole or as a means to escape the obligation to collect margin from third parties. This could occur, for example, if an affiliate in a jurisdiction that does not have comparable margin requirements enters into a swap with a third party without collecting margin, and then enters into an affiliate swap to transfer that risk. Our rule imposes a strong anti-evasion standard. A CSE is required to collect margin from an affiliate if that affiliate is, directly or indirectly, engaging in an outward facing swap in a situation where it should be, but is not, collecting margin. In addition, our proposal on the cross-border application of our margin rule, which is the subject of a separate rulemaking, also addresses this. The proposal provides that any affiliate that is consolidated with a U.S. parent is subject to requirements to collect margin from third parties no matter where the affiliate is located and whether or not it is guaranteed by the U.S. parent.

We have seen how global financial institutions have changed their business models to "deguarantee" the transactions of their overseas swap dealers so as to circumvent certain U.S. requirements. Whether guaranteed or not, swap risk created by an affiliate abroad could harm our financial system. That is why we have a strong anti-evasion standard in this rule and why we are addressing this through the cross-border aspects of the rule. I hope that we can finalize that part of the rule early next year.

In addition, our rule requires segregation of margin and prohibits rehypothecation, which prevents the affiliate that created the outward exposure from using the margin for something else, thus leaving itself more vulnerable to a default.

Second, we have required that variation margin be exchanged for all inter-affiliate swaps. This provides mark-to-market protection to either side, and prevents the potential buildup of a liability owed by one affiliate to another.

Third, we have required that inter-affiliate swaps be subject to a centralized risk management program that is reasonably designed to monitor and to manage the risks associated with such transactions. Some have suggested that, even if inter-affiliate swaps do not increase exposure to third parties, we should require initial margin for all inter-affiliate swaps to enhance that internal risk management. But that would be a very costly and not very effective way for us as a regulator to enhance such risk management. For example, it would not make sense to have a rule that required initial margin on, say, a $100 million inter-affiliate swap, when one affiliate could loan the other $100 million and not collect *any* margin. Similarly, a CSE could collect Treasury securities (or other non-cash collateral) from an affiliate as initial margin, but then loan the same amount of other securities back to the affiliate in a separate transaction which is not subject to requirements. The point is, if the concern is the adequacy of central risk management, then we should focus on that subject more generally. We should not attempt to address it by imposing on all inter-affiliate trades an initial margin requirement that is designed to address default risk on trading relationships between unaffiliated parties.

It is also important to remember that the definition of "affiliate" in our rule is limited to consolidated entities. This means that any swap with an affiliate that is not consolidated would be subject to the same margin requirements as third party swaps. This would be the case, for example, if a swap dealer enters into a swap with a mutual fund managed by an affiliate.

The fact that we are not generally requiring an exchange of initial margin in inter-affiliate transactions is also consistent with the rule this Commission adopted in 2013, which provided an exception to the clearing mandate for inter-affiliate transactions. In that rulemaking, the Commission considered, but decided against, requiring the exchange of initial margin *or* variation margin as a condition for electing the exemption. It did so out of a concern that such requirements "would limit the ability of U.S. companies to efficiently allocate risk among affiliates and manage risk centrally." A requirement to exchange initial margin on all uncleared inter-affiliate transactions would effectively contravene the inter-affiliate clearing exemption, as it would likely be cheaper to clear the inter-affiliate swap. However, I think the case for variation margin is different, and that is why I support imposing a general requirement for exchange of variation margin for inter-affiliate swaps. While this goes further than what the Commission did in 2013, I believe it is a necessary and reasonable addition to the overall protections of the rule.

In addition to the goal of minimizing systemic risk, I also considered our desire to harmonize with the prudential regulators and international standards as much as possible, so that we do not create inconsistencies in the regulatory framework or incentives for regulatory arbitrage. The prudential regulators' rules require the exchange of variation margin in inter-affiliate transactions, as ours do. They did not require the two-way exchange of initial margin; instead they required a "collect only" approach. This is similar to what federal law already requires, as Section 23 A and B of the Federal Reserve Act imposes requirements on inter-affiliate transactions by insured depositary institutions designed to protect the insured depository institutions. Those requirements do not apply to CSEs subject to our rule. In addition, if we were to adopt a collect only approach to initial margin, it would result in the two-way approach for transactions between the CFTC's CSEs and the CSEs subject to the prudential regulators' rules that the prudential regulators did not adopt.  Instead, we have required the posting of initial margin to affiliated CSEs regulated by the prudential regulators to ensure consistency with the requirements of the prudential regulators' rules.  By doing so, we can help enforce the prudential regulators' goal and the existing Section 23 framework.

With respect to international harmonization, we expect the rules to be adopted soon by Europe and Japan to not require initial or variation margin for inter-affiliate swaps.  Similarly, the joint Basel Committee on Banking Supervision and the International Organization of Securities Commissions standards agreed upon in 2013 stated that the exchange of initial or variation margin for inter-affiliate swaps is "not customary" and expressed concern that imposing such requirements would result in "additional liquidity demands."  Our rule is somewhat more conservative than the international standards, but I believe the differences are not so great as to create significant international disparities.

In conclusion, the differences in our views on inter-affiliate margin do not reflect differences in the level of concern about the safety of the system or avoiding the problems of the past.  They reflect differences in our analysis of what is accomplished by inter-affiliate initial margin.  I believe the rule we are adopting today is a strong and sensible approach that will contribute to the strength and resiliency of our financial system.

**Appendix 3 – Dissenting Statement of Commissioner Sharon Y. Bowen**

I commend the staff, the Chairman, and Commissioner Giancarlo for their work on this final rule. This rule has many benefits for the American public and is an important step towards further girding the financial system. Unfortunately, as compared to our September, 2014 proposal and the rule passed by the prudential regulators, this final rule fails to meet statutory intent and it puts swap dealers we regulate at greater risk in times of financial stress because of its treatment of interaffiliate margin.

In 2008, our financial system was brought to its knees as a tidal wave of financial risk washed away the savings of many, destroyed confidence in the financial system, and swept away platitudes about large, sophisticated, financial players' ability to manage their own credit risks. This crisis was considerably compounded by derivatives transactions that were unregulated and woefully under-collateralized.

While these large players were bailed out by taxpayers, today they have returned to record profits. Many of those same taxpayers had no similar help. No recourse to the financial institutions that harmed them. No help to pick up the pieces and rebuild a financial future.

In the aftermath, the international regulatory community recognized that margin requirements for uncleared swaps are a critical safeguard against repeating these mistakes. They provide covered entities with protections against counterparty default. Crucially, initial margin is a protection paid by the "defaulter." These defaulter-paid protections help entities recognize the risk they take and impose on others. Variation margin, on the other hand, force entities to recognize losses they have already incurred.

Together, variation margin and initial margin reduce systemic risk and excess leverage. They help ensure the parties have the capacity to perform on the swap over time.

In 2010, the Dodd Frank Wall Street Reform and Consumer Protection Act ("Dodd Frank") recognized the higher risk swap dealers faced from using uncleared swaps. Dodd Frank mandated margin requirements to protect the safety and soundness of swap dealers using uncleared swaps.

In 2011, the Group of Twenty (G20) added margin requirements on uncleared derivatives to the global financial reform agenda.

In September, 2013, following the G20 agenda, the Basel Committee on Banking Supervision ("BCBS") and International Organization for Securities Commissions ("IOSCO") released a framework for margin requirements for uncleared derivatives (the "BCBS/IOSCO Framework").[1] This framework highlighted the increased risk posed by uncleared derivatives as the "same type of systemic contagion and spillover risks"[2] involved in the 2008 financial crisis. The Framework also found that margin requirements for uncleared derivatives would promote central clearing.[3]

In September, 2014, the Commission re-proposed its 2011 rule on uncleared margin, updating it to reflect the Framework and working with the prudential regulators to develop a proposal that was consistent with theirs.

Unfortunately, the rule before us is a considerable retreat from the September proposal. This final rule provides an exemption for swap dealers, excusing them from collecting initial margin when entering into transactions with most affiliated parties

[1] BCBS/IOSCO, Margin requirements for non-centrally cleared derivatives ("BCBS/IOSCO Framework") (September 2013).
[2] Id. at 2.
[3] Ibid.

including prudentially regulated swap dealers, i.e., swap dealers that are also banks. It also includes, in most cases, under-capitalized affiliates, foreign affiliates, and even unregulated affiliates.

As the prudential regulators noted in their recently released final rule, these swaps "may be significant in number and notional amount."[4] As I understand from our staff, interaffiliate transactions likely make up nearly half of all uncleared transactions by notional volume.

Initial margin functions like a performance bond. Collected from your counterparty, it helps ensure that even as one party defaults on you, you will be able to perform on your obligations to others. Posted and collected across the financial system, it is a critical shock absorber for the bumps and potholes of our financial markets and for the risk of contagion and spillovers.

The large financial institutions that benefit from this exemption have tremendously complicated organizational structures, webs of hundreds, sometimes thousands, of affiliates spread across the globe. These complicated structures allow these banks to shift risk across the globe through different legal entities in their quest to earn higher returns on capital.

The difference in political, financial, and legal systems across these interconnected, international affiliate webs makes it difficult, likely impossible, to fully predict how risk unfolds across the global entity in a period of severe financial stress.

Think of immunizations. We have them to protect our population against the risk of infectious disease, not just for us as individuals, but to keep disease from spreading

[4] 80 FR 74840 (November 30, 2015) at 74889.

across our communities. Immunizations are not always enough, people still get sick, but they are a vital protective measure. People do forgo them, perhaps hoping that they either are not going to get sick, or if they do, that they can be treated. But, we know, hope is not enough. The whole point of immunizations is protecting against dangerous, but preventable, risks.

Initial margin fulfills a similar role. Legally, the affiliates we are talking about here are separate entities, even if they are part of a larger company structure. If their transactions across affiliates create risk, that risk should be addressed. For uncleared swaps, initial margin helps immunize individuals, institutions and ultimately the whole financial system from financial disease and contagion.

In November of this year, the prudential regulators decided to allow, subject to conditions, dealers to collect but not post initial margin with affiliates. The prudential regulators noted this accommodation would meet the twin goals of “protect[ing] the safety and soundness of covered swap entities in the event of an affiliated counterparty default” while not “permit[ting] such inter-affiliate swaps … to remain unmargined and thus to pose a risk to systemic stability.” According to the statute, our rules are to be comparable, “to the maximum practicable” to those of our fellow prudential regulators.[5]

While this rule today is, in many respects consistent with that of the prudential regulators, regarding interaffiliate initial margin it is neither comparable to that of the prudential regulators, nor does it protect safety and soundness of swap dealers we oversee. It places the swap dealers we regulate, and thus, their customers, at unnecessary risk in times of financial stress.

[5] 7 U.S.C. 6s(e)(3)(D)(ii).

The situation of a CFTC-regulated swap dealer transacting with a prudentially regulated swap dealer is particularly problematic. Not only does the CFTC-regulated swap dealer not have the benefit of collecting initial margin, it has to post initial margin to the prudentially-regulated swap dealer. For entities with high volumes of affiliate transactions, this can leave these CFTC-regulated swap dealers in a huge hole in the case of default. By not collecting initial margin, this rule places the swap dealers we regulate at greater risk in times of severe financial stress. That cannot be consistent with the intent of a statute mandating us to protect the "safety and soundness" of our swap dealers.

By not requiring the collection of interaffiliate initial margin for this significant number of trades, we lose a vital financial shock absorber that is intended to help immunize institutions and the system against the risk of default.

We should not minimize the risk of this action. One could say that having our swap dealers collect initial margin is not necessary because a large financial institution is never going to let one of its affiliates go under. Do we want to risk the health of our economy on that bet? Especially since, relying on financial entities to properly risk manage, without regulatory limitations, did not work in 2008?

The rationale noted in this rule for allowing this loophole seems to be in order to reduce the margin amount collected by the overall enterprise. But, we are charged with protecting the "safety and soundness" of swap dealers.[6] We need to address the risks that cause a particular swap dealer to fail. Especially, those risks that might cause a swap dealer to fail to meet its obligations to its customers or protect its customers' funds.

[6] 7 U.S.C. 6s(e)(3)(A)(i).

I do not know, for a particular swap dealer, what circumstances might arise that would send it careening towards another financial crash. I cannot predict whether collecting interaffiliate initial margin will be enough to protect the swap dealer and ultimately its customers. I do know that having collateral in the form of initial margin makes it more likely the swap dealer will meet its obligations than not having it.

This decision seems to reflect a forgetfulness about how we, as a country, allowed the last financial crisis to happen. It is easy to believe that large, complex financial institutions can manage their risks. They are smart people. They make a lot of money. They have to know what they are doing.

However, the risks we are dealing with are hard to quantify. They are the kinds of risks that humans have shown, throughout history, they are quite poor at managing.

Most institutions for whom these transactions are relevant, failed in 2008 to manage the risk of these transactions. This action today seems to be a return to blindly trusting in large financial institutions' ability and willpower to manage their risks adequately. Are we really willing to make that bet again?

I am not.

Our prudential colleagues have agreed that initial margin is the correct tool to manage the risks of transactions across affiliates. We should not be trying to guess whether a large, complex financial institution's global risk controls will be sufficient to protect the swap dealers we regulate. Our failure to provide comparable protection for our swap dealers is inexplicable to me.

I have been responsible for dealing with customers who have lost their life savings when complex financial entities collapse. I cannot vote for a rule that places the swap dealers we regulate, and most importantly, their customers, at risk. Accordingly, I vote no.

**Appendix 4 – Statement of Commissioner J. Christopher Giancarlo**

Today's final rule regarding margin requirements for uncleared swaps is far from perfect. The Commission had the unenviable task of harmonizing its rule with the prudential regulators' rules and with standards issued by the Basel Committee on Banking Supervision and the International Organization of Securities Commissions (BCBS/IOSCO). While there are particular provisions of the final rule that I do not support, I think the final rule is far better balanced than the previous proposal.

Much of the discussion in finalizing this rule has been focused on margin requirements for inter-affiliate swaps. That discussion must begin with the recognition that inter-affiliate swaps transactions do not involve transactions between distinct financial institutions that was at issue in the 2008 financial crisis and do not pose the systemic risk that the Dodd-Frank Act[1] was ostensibly designed to address. Congress expressed no particular intention to subject inter-affiliate transactions to clearing or inter-affiliate margin.

Accordingly, the CFTC adopted a rule in April 2013 to exempt certain inter-affiliate swaps from mandatory clearing.[2] That rulemaking, supported by former Chairman Gensler and Commissioners Wetjen, Chilton and O'Malia, recognized that inter-affiliate swaps provide an important risk management role within corporate groups. They enable use of a single conduit on behalf of multiple affiliates to net affiliates'

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, 124 Stat. 1376 (2010).
[2] Clearing Exemption for Swaps Between Certain Affiliated Entities, 78 FR 21750 (Apr. 11, 2013); 17 CFR 50.52.

trades, which reduces the overall risk of the corporate group and the number of outward-facing swaps into which the affiliates might otherwise enter. This, in turn, reduces operational, market, counterparty credit and settlement risk.[3] Rather than increasing risk, inter-affiliate swaps allow entities within a corporate group to transfer risk to the group entity best positioned to manage it.

Moreover, in exercising its authority under Section 4(c) of the Commodity Exchange Act to exempt qualifying inter-affiliate swaps from the mandatory clearing requirement, the Commission found that the exemption promotes responsible financial innovation, fair competition and is consistent with the public interest.[4] It further found that the exemption, which was conditioned on having certain risk mitigating measures in place,[5] would not have a material effect on the Commission's ability to discharge its regulatory responsibilities.[6]

When the CFTC issued its proposed rule in September 2014, I noted that subjecting inter-affiliate swaps to the higher costs of uncleared margin[7] could not be logically or prudentially justified with the clearing exemption for inter-affiliate swaps

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[3] *Id.* at 21753.
[4] *Id.* at 21754.
[5] For example, the clearing exemption may be elected only if the affiliates' financial statements are consolidated, which increases the likelihood that the affiliates will be mutually obligated to meet the group's swap obligations; the affiliates must be subject to a centralized risk management program; and outward-facing swaps must be cleared or subject to an exemption or exception from clearing. *Id.* at 21753.
[6] *Id.* at 21754.
[7] The costs of posting margin for uncleared swaps will likely be substantially higher than the costs associated with clearing. For example, the minimum liquidation time for cleared agricultural, energy and metals swaps is one-day for purposes of calculating initial margin, and five days for cleared interest rate and credit default swaps. Commission Regulation 39.13(g)(2). Under the final rule, initial margin for uncleared swaps may be calculated under either a standardized table-based method or a model-based method. Under the table-based method, initial margin for commodity swaps must equal 15 percent of gross notional exposure. The model-based method requires a ten-day close out period for all swaps regardless of the underlying liquidity characteristics.

that the Commission adopted in 2013.[8] The Commission's 2013 findings remain valid on this issue. I am aware of no facts that have come to light that would change the original assessment made by our predecessor Commission.

In fact, since issuing the proposed rule for notice and comment, an independent cost-benefit analysis of the rule recommended, among other things, exempting inter-affiliate swaps from initial margin requirements as a means to reduce the "excessively onerous" impact of the rule on competition, price discovery and overall market efficiency without allowing additional systemic risk.[9] I concur with that recommendation.

Earlier this year, I testified before the U.S. House of Representatives Committee on Agriculture Subcommittee on Commodity Exchanges, Energy, and Credit. In response to a question, I explained that the cost of any requirement to impose initial margin in inter-affiliate transactions would have two likely impacts: first, it would raise the cost of commercial risk hedging for American end-users; and second, it would encapsulate risk in the U.S. marketplace and thus increase the risk of systemic hazard in American financial markets.[10]

The final rule before us today is not naïve or reckless concerning inter-affiliate swaps transactions. It recognizes that they are not without risk and sets appropriate safeguards. First, the rule requires operation of a centralized risk management program

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[8] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants; Proposed Rule, 79 FR 59898, 59936 (Oct. 3, 2014) (Statement of Commissioner J. Christopher Giancarlo), *available at* http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2014-22962a.pdf.

[9] Cost-Benefit Analysis of the CFTC's Proposed Margin Requirements for Uncleared Swaps, NERA Economic Consulting (Dec. 2, 2014), *available at* http://www.nera.com/content/dam/nera/publications/2014/NERA_Margin_Requirements_Uncleared_Swaps.pdf.

[10] Hearing before the Subcommittee on Commodity Exchanges, Energy, and Credit of the Committee on Agriculture, House of Representatives, 114th Congress, First Session, Serial No. 114-7, Transcript at 193-194 (Apr. 14, 2015), *available at* http://agriculture.house.gov/uploadedfiles/114-07_-_93966.pdf.

for such swaps. Second, variation margin will be required. Third, the rule requires covered swap entities to collect initial margin from non-U.S. affiliates that are not subject to comparable initial margin collection requirements for their own outward-facing swaps with financial entities. These measures appropriately address the risks associated with uncleared inter-affiliate swaps.[11]

In other regards, I am satisfied that the threshold for measuring material swaps exposure has been raised from $3 billion to $8 billion, which brings our requirement roughly in line with the BSBS/IOSCO standard of €8 billion.[12] I am also pleased that the swaps of commercial end-users, agricultural and energy cooperatives that are classified as financial institutions and small banks will not be subject to the margin requirements if they qualify for an exclusion or exemption. That is one small assist to America's remaining small banks to get their heads back above water in the toppling wake of the Dodd-Frank Act.

I disagree, however, with the definition of "financial end user," which is overly broad. It includes entities that are unlikely to act as counterparties to swaps such as floor brokers, introducing brokers and futures commission merchants acting on behalf of customers, among others. These entities may not ultimately be captured by the rule because they are unlikely to have material swaps exposure triggering application of the rule, but I question the logic behind their inclusion. Good regulation means precisely crafted rules, not ones that are deliberately overly-broad.

[11] AIG often did not post initial margin or pay variation margin on its outward facing swaps. *See* Opening Statement of Commissioner Michael V. Dunn, Public Meeting on Proposed Rules Under Dodd-Frank Act (Apr. 12, 2011). Both are required under today's rule.

[12] I note an inconsistency between the $8 billion *de minimis* threshold for purposes of determining who must register as a swap dealer or major swap participant and the $8 billion threshold for measuring material swaps exposure. Foreign exchange swaps, foreign exchange forwards and hedging swaps must be included in the calculation of material swaps exposure; they are not included in calculating the *de minimis* threshold.

I also continue to object to the ten-day liquidation horizon that must be incorporated into initial margin models for all types of uncleared swaps. The ten-day requirement is a made up number that is not tailored to the true liquidity profile of the underlying swap instruments. I call upon my fellow regulators to revisit this issue as we gain more experience with initial margin models.

Another item that requires further Commission action is to codify by rule the no-action letters providing clearing relief to certain Treasury affiliates acting as principal.[13] The prudential regulators were unwilling to recognize the no-action relief in their final rules, but have indicated that if the Commission acts to exclude these entities by rule, they would also be excluded from the prudential regulators' rules. The Commission should act to issue a rule without delay.

In addition, I remain concerned about the cross-border implications for this rule, which remain unfinished because they were proposed separately from the rule finalized today.[14] As I stated at the time of the cross-border rule proposal, I have many concerns and questions surrounding that rulemaking, including: (1) the shift away from the transaction-level approach set forth in the July 2013 Cross-Border Interpretive Guidance and Policy Statement; (2) the revised definitions of "U.S. person" (defined for the first time in an actual Commission rule) and "guarantee" and how these new terms will be interpreted and applied by market participants across their entire global operations; (3) the scope of when substituted compliance is allowed; and (4) the practical implications of

[13] *See* CFTC No-Action Letter No. 13-22 (Jun. 4, 2013); CFTC No-Action Letter No. 14-144 (Nov. 26, 2014).
[14] *See* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants—Cross-Border Application of the Margin Requirements; Proposed Rule, 80 FR 41376 (Jul. 14, 2015), *available at* http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2015-16718a.pdf.

permitting substituted compliance, but disallowing the exclusion from CFTC margin requirements for certain non-U.S. covered swap entities.[15]

An appropriate framework for the cross-border application of margin requirements for uncleared swaps is essential if we are to preserve the global nature of the swaps market. I reiterate a few of my concerns with the yet-to-be-finished cross-border element of the margin for uncleared swaps regime because that proposal and this final rule must work in harmony. We must avoid further fragmenting the global swaps markets by imposing another regulatory framework that is inconsistent, confusing or burdensome. Doing so will only result in yet another competitive disadvantage between American institutions and their international counterparts.

I am disappointed that the Commission decided to treat the results of portfolio compression of legacy swaps as new swaps subject to the margin rule at this time. In 2013 the Division of Clearing and Risk (DCR) determined that it would not recommend enforcement action for the failure of market participants to submit to clearing amended or replacement swaps that are generated as part of a multilateral portfolio compression exercise and are subject to required clearing, provided that certain conditions are met.[16] Staff recognized in issuing the no-action relief that "multilateral portfolio compression allows swap market participants to net down the size and/or number of outstanding swaps, and decrease the number of outstanding swaps or the aggregate notional value of such swaps, thereby reducing operational risk and, in some instances, reducing counterparty credit risk."[17]

[15] *Id.* at 41407.
[16] CFTC Letter No. 13-01.
[17] *Id.* at 2.

Portfolio compression is of great benefit to the safety and soundness of the market. It should be incentivized, not penalized. Treating swaps created by compressing legacy swaps as new swaps subject to margin requirements may well discourage portfolio compression. Moreover, it is inconsistent with the DCR staff no-action relief. This is a missed opportunity. I urge the Commission to revisit this issue prior to implementation of the margin requirements.

From my perspective, the most objectionable aspect of today's rule is its foundation in the superficial logic that, if the cost of margining uncleared swaps is forced high enough, then market participants will use more cleared instruments.[18] That foundation is not supported by either reason or experience. If no clearinghouse is willing to clear a particular swap, then no amount of punitive cost will enable it to be cleared.

I know this because I was involved before the financial crisis in one of the first independent efforts by non-Wall Street banks to develop a central clearing house for credit default swaps.[19] For years, I have expressed my support for increased central counterparty clearing of swaps[20] and continue to support it where appropriate. Yet, I also

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[18] *See* Chair Janet L. Yellen, Opening Statement on the Long-Term Debt and Total Loss-Absorbing Capacity Proposal and the Final Rule for Margin and Capital Requirements for Uncleared Swaps, Board of Governors of the Federal Reserve System, Oct. 30, 2015, *available at* http://www.federalreserve.gov/newsevents/press/bcreg/yellen-statement-20151030a.htm; *see also* Madigan, Peter, *US Margin Rules Threaten Clearing Bottleneck*, Risk.net, Dec. 14, 2015.

[19] *See, e.g.*, GFI Group Inc. and ICAP plc To Acquire Ownership Stakes In The Clearing Corporation, PRNewswire, Dec. 21, 2006, *available at* http://www.prnewswire.com/news-releases/gfi-group-inc-and-icap-plc-to-acquire-ownership-stakes-in-the-clearing-corporation-57223742.html; *see also*, Testimony Before the H. Committee on Financial Services on Implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 112th Cong. 8 (2011) (statement of J. Christopher Giancarlo) ("In 2005, GFI Group and ICAP Plc, a wholesale broker and fellow member of the WMBAA, took minority stakes in the Clearing Corp and worked together to develop a clearing facility for credit default swaps. That initiative ultimately led to greater dealer participation and the sale of the Clearing Corp to the Intercontinental Exchange and the creation of ICE Trust, a leading clearer of credit derivative products.").

[20] *See* Testimony Before the H. Committee on Financial Services on Implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 112th Cong. 8 (Feb. 21, 2011), *available at* http://financialservices.house.gov/media/pdf/021511giancarlo.pdf; *see also* WMBAA Press Release,

recognize that central counterparty clearing is not a panacea for counterparty credit risk.[21] As regulators, we must be intellectually honest and acknowledge that there are legitimate and vital needs for both cleared and uncleared swaps markets in a modern, complex economy.

As I have previously said,[22] uncleared swaps allow businesses to avoid basis risk and obtain hedge accounting treatment for more complex, non-standardized exposures. Uncleared swaps are an unmatched tool for customized risk management by businesses, governments, asset managers and other institutions whose operations are essential to American economic growth. Their precise risk transfer utility generally cannot be replicated with standardized cleared derivatives without resulting in improper or imperfect hedges or hedges that fail hedge accounting treatment under U.S. GAAP.

Today's rule also reflects a disingenuous reading of the Dodd-Frank Act to favor cleared derivatives over uncleared swaps. In fact, there is no provision in the law directing regulators to set punitive levels of margin to drive hedging market participants toward cleared products. Imposing punitive margin levels will hazard a range of adverse consequences from raising the commercial cost of risk hedging to reducing trading liquidity in uncleared swaps markets and incentivizing movement of products otherwise unsuitable for clearing into clearinghouses into which counterparty risk is already increasingly concentrated. More critically, punitive margin on uncleared swaps will

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*WMBAA Commends Historic US Financial Legislation*, Jul. 21, 2010, *available at* http://www.wmbaa.com/wp-content/uploads/2012/01/WMBAA-Dodd-Frank-Law-press-release-final123.pdf.

[21] *See* CFTC Commissioner J. Christopher Giancarlo, *Pro-Reform Reconsideration of the CFTC Swaps Trading Rules: Return to Dodd-Frank* (Jan. 29, 2015), *available at* http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/sefwhitepaper012915.pdf.

[22] *See* Opening Statement of Commissioner J. Christopher Giancarlo, Open Meeting on Proposed Rule on Margin Requirements for Uncleared Swaps and Final Rule on Utility Special Entities, Sept. 17, 2014, *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/giancarlostatement091714.

increase the amount of inadequately hedged risk exposure on America's corporate balance sheets exacerbating volatility in earnings and share prices.

Yet, I know that my voice alone cannot reverse the course of the present prevalence of "macro-prudential" regulation that prioritizes systemic stability over investment opportunity, market vibrancy and economic growth. Only time will show that systemic risk cannot be managed through centralized economic planning. In fact, rather than being managed, systemic risk is being transformed today from counterparty credit exposure to jarring volatility spikes and liquidity risk across the breadth of financial markets, with ramifications that will be even harder to manage in the future.

Unfortunately, today's rule will not reverse these trends. I will vote for the rule, not because it is the right prescription for uncertain markets, but because it is much better than originally proposed and less harmful than likely alternatives.

I commend the CFTC staff for their hard work, thoughtfulness and, ultimately, the generally improved rulemaking that is before us today.