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COMMODITY FUTURES TRADING COMMISSION

17 CFR Chapter I

Comparability Determination for the European Union: Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants

AGENCY: Commodity Futures Trading Commission.

ACTION: Notification of determination.

SUMMARY: The following is the analysis and determination of the Commodity Futures Trading Commission ("Commission") regarding a request by the European Commission ("EC") that the Commission determine that laws and regulations applicable in the European Union ("EU") provide a sufficient basis for an affirmative finding of comparability with respect to margin requirements for uncleared swaps applicable to certain swap dealers ("SDs") and major swap participants ("MSPs") registered with the Commission. As discussed in detail herein, the Commission has found the margin requirements for uncleared swaps under the laws and regulations of the EU comparable in outcome to those under the Commodity Exchange Act ("CEA") and Commission regulations.

DATES: This determination was made and issued by the Commission on October 13, 2017.

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SUPPLEMENTARY INFORMATION:

I. Introduction

Pursuant to section 4s(e) of the CEA,[1] the Commission is required to promulgate margin requirements for uncleared swaps applicable to each SD and MSP for which there is no Prudential Regulator (collectively, "Covered Swap Entities" or "CSEs").[2] The Commission published final margin requirements for such CSEs in January 2016 (the "Final Margin Rule").[3]

Subsequently, on May 31, 2016, the Commission published in the *Federal Register* its final rule with respect to the cross-border application of the Commission's margin requirements for uncleared swaps applicable to CSEs (hereinafter, the "Cross-Border Margin Rule").[4] The Cross-Border Margin Rule sets out the circumstances under which a CSE is allowed to satisfy the requirements under the Final Margin Rule by complying with comparable foreign margin requirements ("substituted compliance");

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[1] 7 U.S.C. 1 *et. seq*.

[2] *See* 7 U.S.C. 6s(e)(1)(B). SDs and MSPs for which there is a Prudential Regulator must meet the margin requirements for uncleared swaps established by the applicable Prudential Regulator. 7 U.S.C. 6s(e)(1)(A). *See also* 7 U.S.C. 1a(39) (defining the term "Prudential Regulator" to include: the Board of Governors of the Federal Reserve System; the Office of the Comptroller of the Currency; the Federal Deposit Insurance Corporation; the Farm Credit Administration; and the Federal Housing Finance Agency). The Prudential Regulators published final margin requirements in November 2015. *See* Margin and Capital Requirements for Covered Swap Entities, 80 FR 74840 (Nov. 30, 2015) ("Prudential Regulators' Final Margin Rule").

[3] *See* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 FR 636 (Jan. 6, 2016). The Final Margin Rule, which became effective April 1, 2016, is codified in part 23 of the Commission's regulations. *See* §§ 23.150 – 23.159 and 23.161. The Commission's regulations are found in Chapter I of Title 17 of the Code of Federal Regulations, 17 CFR parts 1 through 199.

[4] *See* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants – Cross-Border Application of the Margin Requirements, 81 FR 34818 (May 31, 2016). The Cross-Border Margin Rule, which became effective August 1, 2016, is codified in part 23 of the Commission's regulations. *See* § 23.160.

offers certain CSEs a limited exclusion from the Commission's margin requirements; and outlines a framework for assessing whether a foreign jurisdiction's margin requirements are comparable in outcome to the Final Margin Rule ("comparability determinations"). The Commission promulgated the Cross-Border Margin Rule after close consultation with the Prudential Regulators and in light of comments from and discussions with market participants and foreign regulators.[5]

On November 22, 2016, the EC (the "applicant") submitted a request that the Commission determine that laws and regulations applicable in the EU provide a sufficient basis for an affirmative finding of comparability with respect to the Final Margin Rule.[6] The Commission's analysis and comparability determination for the EU regarding the Final Margin Rule is detailed below.

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[5] In 2014, in conjunction with re-proposing its margin requirements, the Commission requested comment on three alternative approaches to the cross-border application of its margin requirements: (i) a transaction-level approach consistent with the Commission's guidance on the cross-border application of the CEA's swap provisions, *see* Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 FR 45292 (July 26, 2013) (the "Guidance"); (ii) an approach consistent with the Prudential Regulators' proposed cross-border framework for margin, *see* Margin and Capital Requirements for Covered Swap Entities, 79 FR 57348 (Sept. 24, 2014); and (iii) an entity-level approach that would apply margin rules on a firm-wide basis (without any exclusion for swaps with non-U.S. counterparties). *See* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 FR 59898 (Oct. 3, 2014). Following a review of comments received in response to this release, the Commission's Global Markets Advisory Committee ("GMAC") hosted a public panel discussion on the cross-border application of margin requirements. *See* GMAC Meeting (May 14, 2015), transcript and webcast available at http://www.cftc.gov/PressRoom/Events/opaevent_gmac051415.

[6] The Commission understands that competent authorities in the individual EU Member States have direct supervisory authority over CSEs in their respective Member State with respect to the EU margin requirements (as defined below) and are responsible for administering those margin requirements. Nevertheless, given that the EU comprises the Member States and the EU margin requirements are directly applicable in the Member States, the Commission recognizes the EC as the relevant foreign regulatory authority for purposes of § 23.160(c)(1)(ii).

II. Cross-Border Margin Rule

A. Regulatory Objective of Margin Requirements

The regulatory objective of the Final Margin Rule is to further the congressional mandate to ensure the safety and soundness of CSEs in order to offset the greater risk to CSEs and the financial system arising from the use of swaps that are not cleared.[7] As the Commission has previously stated, the primary function of margin is to protect a CSE from counterparty default, allowing it to absorb losses and continue to meet its obligations using collateral provided by the defaulting counterparty. While the requirement to post margin protects the counterparty in the event of the CSE's default, it also functions as a risk management tool, limiting the amount of leverage a CSE can utilize by requiring that it have adequate eligible collateral to enter into an uncleared swap. In this way, margin serves as a first line of defense not only in protecting the CSE but in containing the amount of risk in the financial system as a whole, reducing the potential for contagion arising from uncleared swaps.[8]

However, the global nature of the swap market, coupled with the interconnectedness of market participants, also necessitate that the Commission recognize the supervisory interests of foreign regulatory authorities and consider the impact of its choices on market efficiency and competition, which the Commission believes are vital to a well-functioning global swap market.[9] Foreign jurisdictions are at various stages of

[7] *See* 7 U.S.C. 6s(e)(3)(A).

[8] *See* Final Margin Rule, 81 FR 689.

[9] In determining the extent to which the Dodd-Frank swap provisions apply to activities overseas, the Commission strives to protect U.S. interests, as determined by Congress in Title VII, and minimize conflicts with the laws of other jurisdictions, consistent with principles of international comity. *See* Guidance, 78 FR 45300 – 45301 (referencing the Restatement (Third) of Foreign Relations Law of the United States).

implementing margin reforms. To the extent that other jurisdictions adopt requirements with different coverage or timelines, the Commission's margin requirements may lead to competitive burdens for U.S. entities and deter non-U.S. persons from transacting with U.S. CSEs and their affiliates overseas.

B. Substituted Compliance

To address these concerns, the Cross-Border Margin Rule provides that, subject to certain findings and conditions, a CSE is permitted to satisfy the requirements of the Final Margin Rule by complying with the margin requirements in the relevant foreign jurisdiction. This substituted compliance regime is intended to address the concerns discussed above without compromising the congressional mandate to protect the safety and soundness of CSEs and the stability of the U.S. financial system. Substituted compliance helps preserve the benefits of an integrated, global swap market by reducing the degree to which market participants will be subject to multiple sets of regulations. Further, substituted compliance builds on international efforts to develop a global margin framework.[10]

Pursuant to the Cross-Border Margin Rule, any CSE that is eligible for substituted compliance under § 23.160[11] and any foreign regulatory authority that has direct

[10] 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 and the Committee on Global Financial Systems, formed a Working Group on Margining Requirements to develop international standards for margin requirements for uncleared swaps. Representatives of 26 regulatory authorities participated, including the Commission. In September 2013, the Working Group on Margin Requirements published a final report articulating eight key principles for non-cleared derivatives margin rules. These principles represent the minimum standards approved by BCBS and IOSCO and their recommendations to the regulatory authorities in member jurisdictions. *See* BCBS/IOSCO, Margin requirements for non-centrally cleared derivatives (updated March 2015) ("BCBS/IOSCO Framework"), available at http://www.bis.org/bcbs/publ/d317.pdf.

[11] *See* § 23.160(c)(1)(i).

supervisory authority over one or more CSEs and that is responsible for administering the relevant foreign jurisdiction's margin requirements may apply to the Commission for a comparability determination.[12]

The Cross-Border Margin Rule requires that applicants for a comparability determination provide copies of the relevant foreign jurisdiction's margin requirements[13] and descriptions of their objectives,[14] how they differ from the BCBS/IOSCO Framework,[15] and how they address the elements of the Commission's margin requirements.[16] The applicant must identify the specific legal and regulatory provisions of the foreign jurisdiction's margin requirements that correspond to each element and, if necessary, whether the relevant foreign jurisdiction's margin requirements do not address a particular element.[17]

C. Standard of Review for Comparability Determinations

The Cross-Border Margin Rule identifies certain key factors that the Commission will consider in making a comparability determination. Specifically, the Commission will consider the scope and objectives of the relevant foreign jurisdiction's margin requirements;[18] whether the relevant foreign jurisdiction's margin requirements achieve

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[12] *See* § 23.160(c)(1)(ii).

[13] *See* § 23.160(c)(2)(v).

[14] *See* § 23.160(c)(2)(i).

[15] *See* § 23.160(c)(2)(iii). *See also* § 23.160(a)(3) (defining "international standards" as based on the BCBS-ISOCO Framework).

[16] *See* 17 CFR 23.160(c)(2)(ii) (identifying 12 particular elements of the Commission's margin requirements). Section 23.160(c)(2)(ii) largely tracks the elements of the BCBS/IOSCO Framework but breaks them down into their components as appropriate to ensure ease of application.

[17] *See id.*

[18] *See* § 23.160(c)(3)(i).

comparable outcomes to the Commission's corresponding margin requirements;[19] and the ability of the relevant regulatory authority or authorities to supervise and enforce compliance with the relevant foreign jurisdiction's margin requirements.[20]

This process reflects an outcomes-based approach to assessing the comparability of a foreign jurisdiction's margin requirements. Instead of demanding strict uniformity with the Commission's margin requirements, the Commission evaluates the objectives and outcomes of the foreign margin requirements in light of foreign regulator(s)' supervisory and enforcement authority. Recognizing that jurisdictions may adopt different approaches to achieving the same outcome, the Commission will focus on whether the foreign jurisdiction's margin requirements are comparable to the Commission's in purpose and effect, not whether they are comparable in every aspect or contain identical elements.

In keeping with the Commission's commitment to international coordination on margin requirements for uncleared derivatives, the Commission believes that the standards it has established are fully consistent with the BCBS/IOSCO Framework.[21]

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[19] *See* § 23.160(c)(3)(ii). As discussed above, the Commission's Final Margin Rule is based on the BCBS/IOSCO Framework; therefore, the Commission expects that the relevant foreign margin requirements would conform to such Framework at minimum in order to be deemed comparable to the Commission's corresponding margin requirements.

[20] *See* § 23.160(c)(3)(iii). *See also* § 23.160(c)(3)(iv) (indicating the Commission would also consider any other relevant facts and circumstances).

[21] The Final Margin Rule was modified substantially from its proposed form to further align the Commission's margin requirements with the BCBS/IOSCO Framework and, as a result, the potential for conflict with foreign margin requirements should be reduced. For example, the Final Margin Rule raised the material swaps exposure level from $3 billion to the BCBS/IOSCO standard of $8 billion, which reduces the number of entities that must collect and post initial margin. *See* Final Margin Rule, 81 FR at 644. In addition, the definition of uncleared swap was amended to not include swaps cleared by derivatives clearing organizations that are not registered with the Commission but pursuant to Commission orders are permitted to clear for U.S. persons. *See id.* at 638. The Commission notes, however, that the BCBS/IOSCO Framework leaves certain elements open to interpretation (*e.g.*, the definition of "derivative") and expressly invites regulators to build on certain principles as appropriate. *See, e.g.*,

Accordingly, where relevant to the Commission's comparability analysis, the BCBS/IOSCO Framework is discussed to explain certain internationally agreed upon concepts.

The Cross-Border Margin Rule provided a detailed discussion regarding the facts and circumstances under which substituted compliance for the requirements under the Final Margin Rule would be available and such discussion is not repeated here. CSEs seeking to rely on substituted compliance based on the comparability determinations contained herein are responsible for determining whether substituted compliance is available under the Cross-Border Margin Rule with respect to the CSE's particular status and circumstances.

D. Conditions to Comparability Determinations

The Cross-Border Margin Rule provides that the Commission may impose terms and conditions it deems appropriate in issuing a comparability determination.[22] Specific terms and conditions with respect to margin requirements are discussed in the Commission's determinations detailed below.

As a general condition to all determinations, however, the Commission requires notification of any material changes to information submitted to the Commission by the applicant in support of a comparability finding, including, but not limited to, changes in the relevant foreign jurisdiction's supervisory or regulatory regime. The Commission

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Element 4 (eligible collateral) (national regulators should "develop their own list of eligible collateral assets based on the key principle, taking into account the conditions of their own markets"); Element 5 (initial margin) (the degree to which margin should be protected would be affected by "the local bankruptcy regime, and would vary across jurisdictions"); Element 6 (transactions with affiliates) ("Transactions between a firm and its affiliates should be subject to appropriate regulation in a manner consistent with each jurisdiction's legal and regulatory framework.").

[22] *See* 17 CFR 23.160(c)(5).

also expects that the relevant foreign regulator will enter into, or will have entered into, an appropriate memorandum of understanding or similar arrangement with the Commission in connection with a comparability determination.[23]

Finally, the Commission will generally rely on an applicant's description of the laws and regulations of the foreign jurisdiction in making its comparability determination. The Commission considers an application to be a representation by the applicant that the laws and regulations submitted are finalized,[24] that the description of such laws and regulations is accurate and complete, and that, unless otherwise noted, the scope of such laws and regulations encompasses the swaps activities[25] of CSEs[26] in the relevant jurisdictions.[27] Further, the Commission requires that an applicant would notify the Commission of any material changes to information submitted in support of a comparability determination (including, but not limited to, changes in the relevant

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[23] Under Commission regulations 23.203 and 23.606, CSEs must maintain all records required by the CEA and the Commission's regulations in accordance with Commission regulation 1.31 and keep them open for inspection by representatives of the Commission, the U.S. Department of Justice, or any applicable prudential regulator. *See* 17 CFR 23.203, 23.606. The Commission further expects that prompt access to books and records and the ability to inspect and examine a non-U.S. CSE will be a condition to any comparability determination.

[24] The Commission notes that finalized rules of the foreign jurisdiction must be in full force and effect before a CSE may rely on this comparability determination for purposes of substituted compliance.

[25] "Swaps activities" is defined in Commission regulation 23.600(a)(7) to mean, "with respect to a registrant, such registrant's activities related to swaps and any product used to hedge such swaps, including, but not limited to, futures, options, other swaps or security-based swaps, debt or equity securities, foreign currency, physical commodities, and other derivatives." The Commission's regulations under 17 CFR Part 23 are limited in scope to the swaps activities of CSEs.

[26] No CSE that is not legally required to comply with a law or regulation determined to be comparable may voluntarily comply with such law or regulation in lieu of compliance with the CEA and the relevant Commission regulation. Each CSE that seeks to rely on a comparability determination is responsible for determining whether it is subject to the laws and regulations found comparable.

[27] The Commission has provided the relevant foreign regulator(s) with opportunities to review and correct the applicant's description of such laws and regulations on which the Commission will base its comparability determination. The Commission relies on the accuracy and completeness of such review and any corrections received in making its comparability determinations. A comparability determination based on an inaccurate description of foreign laws and regulations may not be valid.

supervisory or regulatory regime) as, depending on the nature of the change, the Commission's comparability determination may no longer be valid.[28]

III. Margin Requirements for Swaps Activities in the EU

As represented to the Commission by the applicant, margin requirements for swap activities in the EU are governed by the Regulatory Technical Standards for Risk-Mitigation Techniques for OTC Derivative Contracts Not Cleared by a Central Counterparty ("RTS").[29] The RTS supplement the requirements of EMIR with a more detailed direction with respect to margin requirements[30] and are directly applicable in all countries that are members of the EU (each country a "Member State"). Article 12 of EMIR further gives Member States the authority to "lay down the rules on penalties" that apply to infringements of the RTS and to take all measures necessary to ensure that those rules are implemented.[31]

IV. Comparability Analysis

The following section describes the regulatory objectives of the Commission's requirements with respect to margin for uncleared swaps imposed by the CEA and the Final Margin Rule and a description of such requirements. Immediately following a description of the requirement(s) of the Final Margin Rule for which a comparability

[28] 78 FR 45345.

[29] Regulation No. 2016/2251 of October 4, 2016 Supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council of July 4, 2012 on OTC Derivatives, Central Counterparties and Trade Repositories with Regard to Regulatory Technical Standards for Risk-Mitigation Techniques for OTC Derivative Contracts Not Cleared by a Central Counterparty (as corrected by Commission Delegated Regulation (EU) 2017/323 of January 20, 2017). Regulation (EU) No 648/2012 of the European Parliament and the Council of July 4, 2012 is more commonly known as the European Market Infrastructure Regulation or "EMIR."

[30] Together, EMIR and RTS are referred to herein as the "EU margin rules," "the EU's margin regime," "EU margin requirements" or the "laws of the EU."

[31] *See* RTS, Article 40 and EMIR, Article 12(1).

determination was requested by the applicant, the Commission provides a description of the foreign jurisdiction's comparable laws, regulations, or rules. The Commission then provides a discussion of the comparability of, or differences between, the Final Margin Rule and the foreign jurisdiction's laws, regulations, or rules.

A. Objectives of Margin Requirements

1. Commission Statement of Regulatory Objectives

The regulatory objectives of the Final Margin Rule are to ensure the safety and soundness of CSEs in order to offset the greater risk to CSEs and the financial system arising from the use of swaps that are not cleared. The primary function of margin is to protect a CSE from counterparty default, allowing it to absorb losses and continue to meet its obligations using collateral provided by the defaulting counterparty. While the requirement to post margin protects the counterparty in the event of the CSE's default, it also functions as a risk management tool, limiting the amount of leverage a CSE can incur by requiring that it have adequate eligible collateral to enter into an uncleared swap. In this way, margin serves as a first line of defense, not only in protecting the CSE, but in containing the amount of risk in the financial system as a whole, reducing the potential for contagion arising from uncleared swaps.[32]

2. EC Statement of Regulatory Objectives

The applicant states that, in the absence of clearing of OTC derivatives by a CCP, it is essential that counterparties apply robust risk-mitigation techniques to their bilateral relationships to reduce counterparty credit risk and to mitigate the potential systemic risk that could arise. Article 11 of EMIR prescribes risk-mitigation techniques for OTC

[32] *See* Cross-Border Margin Rule, 81 FR 34819.

derivative contracts not cleared by a CCP. The RTS supplement EMIR with regard to regulatory technical standards for risk-mitigation techniques for OTC derivative contracts not cleared by a CCP and take into account the Basel Committee-IOSCO margin framework for non-centrally cleared OTC derivatives and the Basel Committee guidelines for managing settlement risk in foreign exchange transactions.[33]

B. Products Subject to Margin Requirements

The Commission's Final Margin Rule applies only to uncleared swaps. Swaps are defined in section 1a(47) of the CEA[34] and Commission regulations.[35] "Uncleared swap" is defined for purposes of the Final Margin Rule in Commission regulation § 23.151 to mean 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.[36]

The EU's margin rules apply to OTC derivatives not cleared by a CCP ("non-centrally cleared OTC derivative").[37] "Derivative" for purposes of the EU margin rules is defined in Article 2(5) of EMIR as a financial instrument as set out in points (4) to (10) of Section C of Annex I to MIFID[38] as implemented by Articles 38 and 39 of EU Regulation

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[33] *See* RTS, Explanatory Memorandum at 3.

[34] 7 U.S.C. 1a(47).

[35] *See, e.g.*, § 1.3(xxx), 17 CFR 1.3(xxx).

[36] 17 CFR 23.151.

[37] *See* EMIR, Article 11(1) and RTS, Recital (1). CCP is defined in Article 2(1) of EMIR to mean "a legal person that interposes itself between the counterparties to the contracts traded on one or more financial markets, becoming the buyer to every seller and the seller to every buyer."

[38] Under MiFID, such financial instruments are:
(4) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to securities, currencies, interest rates or yields, or other derivatives instruments, financial indices or financial measures which may be settled physically or in cash;

No. 1287/2006.[39] Initial margin need not be collected for physically-settled foreign exchange forwards, physically-settled foreign exchange swaps, or cross-currency swaps.[40] Regarding covered bonds for hedging purposes, no variation margin needs to be posted by a covered bond issuer or covered pool but must be collected from a counterparty in cash and returned to a counterparty when due, and no initial margin required.[41]

An OTC derivative is a derivative which is not executed on a regulated market or on a third-country market considered as equivalent to a regulated market.[42] While it is beyond the scope of this comparability determination to definitively map any differences between the definitions of "swap" and "uncleared swap" under the CEA and Commission

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(5) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event);
(6) Options, futures, swaps, and any other derivative contract relating to commodities that can be physically settled provided that they are traded on a regulated market and/or an MTF;
(7) Options, futures, swaps, forwards and any other derivative contracts relating to commodities, that can be physically settled not otherwise mentioned in C.6 and not being for commercial purposes, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are cleared and settled through recognised clearing houses or are subject to regular margin calls;
(8) Derivative instruments for the transfer of credit risk;
(9) Financial contracts for differences;
(10) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to climatic variables, freight rates, emission allowances or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event), as well as any other derivative contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned in this Section, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market or an MTF, are cleared and settled through recognised clearing houses or are subject to regular margin calls.
See MiFID, Annex I, Section C(4)-(10).

[39] Article 38 of EU Regulation No. 1287/2006 further defines the financial instruments described in Point (7) of Section C of Annex I to MiFID to generally be physically-settled FX forwards and swaps. Article 39 of EU Regulation No. 1287/2006 further refines the definition of financial instruments described in Point (10) of Section C of Annex I to MiFID to generally be exchanges of principal of currency swaps.

[40] *See* RTS, Article 27.

[41] *See* RTS, Article 30.

[42] *See* EMIR, Article 2(7).

regulations and the EU's definitions of "OTC derivative" and "non-centrally cleared OTC derivative," the Commission believes that such definitions largely cover the same products and instruments.

However, because the definitions are not identical, the Commission recognizes the possibility that a CSE may enter into a transaction that is an uncleared swap as defined in the CEA and Commission regulations, but that is not a non-centrally cleared OTC derivative as defined under the laws of the EU. In such cases, the Final Margin Rule would apply to the transaction but the EU's margin rules would not apply and thus, substituted compliance would not be available. The CSE could not choose to comply with the EU's margin rules in place of the Final Margin Rule.

Likewise, if a transaction is a non-centrally cleared OTC derivative as defined under the laws of the EU but not an uncleared swap subject to the Final Margin Rule, a CSE could not choose to comply with the Final Margin Rule pursuant to this determination, unless the EU determines that it will permit the EU entity to follow the Commission's margin requirements. CSEs are solely responsible for determining whether a particular transaction is both an uncleared swap and a non-centrally cleared OTC derivative before relying on substituted compliance under the comparability determinations set forth below.

C. Entities Subject to Margin Requirements

As stated previously, the Commission's Final Margin Rule and Cross-Border Margin Rule apply only to CSEs, *i.e.*, SDs and MSPs registered with the Commission for

which there is not a Prudential Regulator.[43] Thus, only such CSEs may rely on the determinations herein for substituted compliance, while CSEs for which there is a Prudential Regulator must look to the determinations of the Prudential Regulators.

CSEs are not required to collect and/or post margin with every uncleared swap counterparty. Under the Final Margin Rule, the initial margin obligations of CSEs apply only to uncleared swaps with counterparties that meet the definition of "covered counterparty" in § 23.151.[44] Such definition provides that a "covered counterparty" is a counterparty that is a financial end user[45] with material swaps exposure[46] or a swap entity[47] that enters into a swap with a CSE. The variation margin obligations of CSEs under the Final Margin Rule apply more broadly. Such obligations apply to

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[43] *See* 7 U.S.C. 6s(e)(1)(B). SDs and MSPs for which there is a Prudential Regulator must meet the margin requirements for uncleared swaps established by the applicable Prudential Regulator. 7 U.S.C. 6s(e)(1)(A). *See also* 7 U.S.C. 1a(39) (defining the term "Prudential Regulator" to include the Board of Governors of the Federal Reserve System; the Office of the Comptroller of the Currency; the Federal Deposit Insurance Corporation; the Farm Credit Administration; and the Federal Housing Finance Agency). The Prudential Regulators published final margin requirements in November 2015. *See* Prudential Regulators' Final Margin Rule, 80 FR 74840 (Nov. 30, 2015).

[44] *See* § 23.152.

[45] *See* definition of "Financial end user" in § 23.150.

[46] *See* § 23.150, which states that "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. That provision further states 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 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.

[47] "Swap entity" is defined in § 23.150 as a person that is registered with the Commission as a swap dealer or major swap participant pursuant to the Act.

counterparties that are swap entities and all financial end users, regardless of their level of material swaps exposure.[48]

As represented by the applicant, the EU's margin rules apply to all financial counterparties, which include investment firms, credit institutions, insurance companies, and alternative investment funds that are authorized or registered in accordance with various EU directives ("FC").[49] CCPs not authorized as credit institutions are outside the scope of Article 11 of EMIR and CCPs authorized as credit institutions are exempt from the RTS.[50] The EU's margin rules also apply to non-financial counterparties (any EU entity other than an FC or a CCP[51]) ("NFC") that are above a certain clearing threshold ("NFC+").[52] Under the EU rules, no margin is required for non-centrally cleared OTC derivatives with NFCs that fall below the clearing threshold ("NFC-") or non-EU entities

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[48] *See* § 23.153.

[49] *See* EMIR, Article 11 (Risk-Mitigation Techniques for OTC Derivative Contracts Not Cleared by a CCP). While the definition of "financial counterparty" under EMIR includes credit institutions authorized in accordance with Directive 2006/48/EU, CCPs that are authorized as credit institutions are exempted from the EU's margin rules. *See* RTS, Article 23. As explained in the RTS, since CCPs might be authorized as a credit institution according to Union legislation, it is necessary to excluded non-centrally cleared OTC derivative contracts that CCPs enter into during a default management process from the requirements of this Regulation since those contracts are already subject to the provisions of Commission Delegated Regulation (EU) No 153/2013 and therefore they are not subject to the provisions of these Regulations.

[50] *See* RTS, Article 23.

[51] *See* EMIR, Article 2(9).

[52] *See* EMIR, Article 11(3) ("[NFCs] … shall have risk-management procedures that require the timely, accurate and appropriately segregated exchange of collateral with respect to OTC derivative contracts that are entered into on or after the clearing threshold is exceeded."). The clearing threshold values are measured by asset class as follows:
(a) EUR 1 billion in gross notional value for OTC credit derivative contracts;
(b) EUR 1 billion in gross notional value for OTC equity derivative contracts;
(c) EUR 3 billion in gross notional value for OTC interest rate derivative contracts;
(d) EUR 3 billion in gross notional value for OTC foreign exchange derivative contracts;
(e) EUR 3 billion in gross notional value for OTC commodity derivative contracts and other OTC derivative contracts not provided for under points (a) to (d).
See Article 11 of Commission Delegated Regulation (EU) No 149/2013 of December 19, 2012 Supplementing EMIR with Regard to Regulatory Technical Standards on Indirect Clearing Arrangements, the Clearing Obligation, the Public Register, Access to a Trading Venue, Non-Financial Counterparties, and Risk Mitigation Techniques for Uncleared OTC Derivatives (pursuant to Article 10(4)(b) of EMIR).

that would be NFC-s if established in the EU.[53] However, under the EU margin rules, counterparties must take into account the different risk profiles of NFC-s when entering into non-centrally cleared OTC derivatives with such counterparties and determine whether or not the level of counterparty credit risk posed by those NFC-s needs to be mitigated through the exchange of collateral.[54] Like the Final Margin Rule, the EU margin rules include a threshold under which initial margin requirements will not apply, while the variation margin requirements apply more broadly.[55]

Given the definitional differences and differences in activity thresholds with respect to the scope of application of the Final Margin Rule and the EU's margin requirements, the Commission notes the possibility that the Final Margin Rule and the EU's margin rules may not apply to every uncleared swap that a CSE may enter into with a EU counterparty. For example, it appears possible that a financial end user with "material swaps exposure" would meet the definition of "covered counterparty" under the Final Margin Rule (and thus the initial and variation margin requirements) while at the same time fall under the EU's clearing threshold (an NFC-) and not be subject the EU margin requirements. It may also be possible that the Final Margin Rule's definition of "financial end user" could capture an entity that is an NFC under the EU's margin regime.

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[53] *See* RTS, Article 24.

[54] *See* RTS, Recital (2).

[55] *See* RTS, Article 28, stating: Counterparties may provide in their risk management procedures that initial margins are not collected for all new OTC derivative contracts entered into within a calendar year where one of the two counterparties has an aggregate month-end average notional amount of non-centrally cleared OTC derivatives for the months March, April and May of the preceding year of below EUR 8 billion. The aggregate month-end average notional amount referred to in the first subparagraph shall be calculated at the counterparty level or at the group level where the counterparty belongs to a group.

With these differences in scope in mind, the Commission reiterates that no CSE may rely on substituted compliance unless it and its transaction are subject to both the Final Margin Rule and the EU's margin rules; a CSE may not voluntarily comply with the EU's margin rules where such law does not otherwise apply. Likewise, a CSE that is not seeking to rely on substituted compliance should understand that the EU's margin rules may apply to its counterparty irrespective of the CSE's decision to comply with the Final Margin Rule.

D. Treatment of Inter-Affiliate Derivative Transactions

The BCBS/IOSCO Framework recognizes that the treatment of inter-affiliate derivative transactions will vary between jurisdictions. Thus, the BCBS/IOSCO Framework does not set standards with respect to the treatment of inter-affiliate transactions. Rather, it recommends that regulators in each jurisdiction review their own legal frameworks and market conditions and put in place margin requirements applicable to inter-affiliate transactions as appropriate.[56]

1. Commission Requirements for Treatment of Inter-Affiliate Transactions

The Commission determined through its Final Margin Rule to provide rules for swaps between "margin affiliates." In defining "margin affiliate," those rules provide that 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

[56] *See* BCBS/IOSCO Framework, Element 6: Treatment of transactions with affiliates.

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 (1) or (2) would have occurred if such principles or standards had applied.[57]

With respect to swaps between margin affiliates, the Final Margin Rule, with one exception explained below, provides that a CSE is not required to collect initial margin[58] 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.[59]

In an exception to the foregoing general rule, the Final Margin Rule does require CSEs to collect initial margin from non-U.S. affiliates that are financial end users that are not subject to initial margin collection requirements on their own outward-facing swaps with financial end users that are not comparable in outcome to the Final Margin Rule.[60] 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

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[57] § 23.151.

[58] "Initial margin" is margin exchanged to protect against a potential future exposure and is defined in § 23.151 to mean the collateral, as calculated in accordance with § 23.154 that is collected or posted in connection with one or more uncleared swaps.

[59] *See* § 23.159(a).

[60] *See* § 23.159(c).

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.[61]

The Commission has stated that its inter-affiliate initial margin requirement is consistent with its goal of harmonizing its margin rules as much as possible with the BCBS/IOSCO Framework. Such Framework, for example, states 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."[62] With an understanding that many authorities, such as those in Europe and Japan, are not expected to require initial margin for inter-affiliate swaps, the Commission recognized that requiring the posting and collection of initial margin for inter-affiliate swaps generally would be likely to put CSEs at a competitive disadvantage to firms in other jurisdictions.

The Final Margin Rule however, does require CSEs to exchange variation margin with affiliates that are SDs, MSPs, or financial end users (as is also required under the Prudential Regulators' rules).[63] The Commission stated that marking open positions to market each day and requiring the posting or collection of variation margin reduces the risks of inter-affiliate swaps.

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[61] *See id.*

[62] *See* BCBS/IOSCO Framework, Element 6: Treatment of transactions with affiliates.

[63] *See* § 23.159(b); *see also* Prudential Regulators' Final Margin Rule, 80 FR 74909.

2. Requirement for Treatment of Inter-Affiliate Derivatives under the Laws of the EU

Under Article 11 of EMIR, the EU's margin requirements generally apply to intragroup transactions as defined in Article 3 of EMIR. Such "intragroup transactions" are defined differently for intragroup transactions in relation to an FC ("FC Intragroup Transactions")[64] and intragroup transactions in relation to an NFC ("NFC Intragroup Transactions" and, together with FC Intragroup Transactions, "Intragroup Transactions").[65] What the EU defines as Intragroup Transactions is generally in keeping with the Commission's definition of "margin affiliate" for purposes of the Final Margin Rule, discussed above.

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[64] Article 3(2) of EMIR defines an "intragroup transaction" for an FC to be:
(a) an OTC derivative contract entered into with another counterparty which is part of the same group, provided that the following conditions are met:
(i) the financial counterparty is established in the Union or, if it is established in a third country, the Commission has adopted an implementing act under Article 13(2) in respect of that third country;
(ii) the other counterparty is a financial counterparty, a financial holding company, a financial institution or an ancillary services undertaking subject to appropriate prudential requirements;
(iii) both counterparties are included in the same consolidation on a full basis; and
(iv) both counterparties are subject to appropriate centralised risk evaluation, measurement and control procedures;
(b) an OTC derivative contract entered into with another counterparty where both counterparties are part of the same institutional protection scheme, referred to in Article 80(8) of Directive 2006/48/EC, provided that the condition set out in point (a)(ii) of this paragraph is met;
(c) an OTC derivative contract entered into between credit institutions affiliated to the same central body or between such credit institution and the central body, as referred to in Article 3(1) of Directive 2006/48/EC; or
(d) an OTC derivative contract entered into with a non-financial counterparty which is part of the same group provided that both counterparties are included in the same consolidation on a full basis and they are subject to an appropriate centralised risk evaluation, measurement and control procedures and that counterparty is established in the Union or in a third-country jurisdiction for which the Commission has adopted an implementing act as referred to in Article 13(2) in respect of that third country.

[65] Article 3(1) of EMIR defines an "intragroup transaction" for an NFC to be:
[A]n OTC derivative contract entered into with another counterparty which is part of the same group provided that both counterparties are included in the same consolidation on a full basis and they are subject to an appropriate centralised risk evaluation, measurement and control procedures and that counterparty is established in the Union or, if it is established in a third country, the Commission has adopted an implementing act under Article 13(2) in respect of that third country.

For Intragroup Transactions between counterparties established in the same Member State, no margin requirements will apply, but only as long as there is no legal impediment to the prompt transfer of own funds or repayment of liabilities between counterparties.[66] A legal impediment to the prompt transfer of own funds and repayment of liabilities shall be deemed to exist where there are actual or foreseen restrictions of a legal nature.[67]

For Intragroup Transactions between counterparties established in different Member States, the EU margin rules generally provide, depending on the nature and location of the counterparties, that such Intragroup Transactions may be excluded from the EU margin requirements but only if, in addition to there being no current or legal impediment to the prompt transfer of own funds or repayment of liabilities between the counterparties, the counterparties (i) have risk management procedures that are sound, robust, and consistent with the level of complexity of the derivative transaction, and (ii) in keeping with the procedures established under the RTS,[68] the counterparties have notified the relevant competent authority[69] or authorities of the intention to use the

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[66] *See* EMIR, Article 11(5); *see also* RTS, Article 33 (Applicable Criteria for the Legal Impediment to the Prompt Transfer of Own Funds and Repayment of Liabilities).

[67] *See* RTS, Article 33. Such restrictions include:
(a) currency and exchange controls;
(b) a regulatory, administrative, legal or contractual framework that prevents mutual financial support or significantly affects the transfer of funds within the group;
(c) any of the conditions on the early intervention, recovery and resolution as referred to in Directive 2014/59/EU of the European Parliament and of the Council (1) are met, as a result of which the competent authority foresees an impediment to the prompt transfer of own funds or repayment of liabilities;
(d) the existence of minority interests that limit decision-making power within entities that form the group;
(e) the nature of the legal structure of the counterparty, as defined in its statutes, instruments of incorporation and internal rules.
See RTS, Article 33(a)-(e).

[68] *See* RTS, Article 32.

[69] *See* EMIR, Article 2(13) for the definition of "competent authority" for purposes of the RTS.

exemption and the authority or authorities have reached a positive decision to allow the exemption.[70] The counterparties to an exempted Intragroup Transaction must publicly disclose information about the exemption.[71]

Where one of the two counterparties in the group is domiciled in a third-country for which an equivalence determination under Article 13(2) of EMIR has not yet been provided, the group has to exchange variation and appropriately segregated initial margins for all the Intragroup Transactions with the subsidiaries in those third-countries.[72] However, the requirements are delayed for three years in these cases.[73] This is to allow enough time for completion of the process to produce the equivalence determinations, while not requiring an inefficient allocation of resources to the groups with subsidiaries domiciled in third-countries.[74] Where an equivalence decision has been made, counterparties may then apply for an exemption pursuant to the timing and process established under EMIR and the RTS.[75]

3. Commission Determination

Having compared the outcomes of the EU's margin requirements applicable to Intragroup Transactions to the outcomes of the Commission's corresponding margin requirements applicable to inter-affiliate swaps, the Commission finds that the treatment of inter-affiliate transactions under the Final Margin Rule and under the EU's margin requirements are comparable in outcome.

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[70] *See* EMIR, Article 11(6) to (10).

[71] *See* EMIR, Article 11(11).

[72] *See* RTS, Recital (40).

[73] *See* RTS, Articles 36 and 37.

[74] *See* RTS, Recital (40).

[75] *See* RTS, Articles 36 and 37.

A CSE entering into a transaction with a consolidated affiliate under the Final Margin Rule would be required to exchange variation margin in accordance with §§ 23.151 through 23.161, and in certain circumstances, collect initial margin in accordance with § 23.159(c). The Commission continues to deem this provision an important anti-evasion measure, designed to prevent the potential use of affiliates to avoid collecting initial margin from third parties.[76] In adopting its Final Margin Rule, the Commission recognized that, in absence of proper anti-evasion measures, a CSE could import risk from another jurisdiction, one with potentially less stringent margin protections, through inter-affiliate trades.[77] In analyzing the EU's margin rules, the Commission specifically notes that the EU margin rules will apply to inter-affiliate trades involving an affiliate that is established in a third-country (non-EU) jurisdiction, unless specifically excluded. Any exclusion from the EU margin rules is subject to an application process, which would require a finding that the relevant non-EU jurisdiction's margin requirements are equivalent. This comparability requirement provides protection to the consolidated entity, as the consolidated entity would not be able to import risk from third country jurisdictions that are not equivalent, without posting and collecting initial margin and exchanging variation margin. Therefore, the Commission believes that the EU's review process for finding comparability in third-country jurisdictions addresses the Commission's anti-evasion concerns relating to inter-affiliate transactions.

In addition, where a CSE and its inter-affiliate counterparty are subject to the Commission's margin requirements and the EU's margin requirements, all of the EU's

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[76] *See* Final Margin Rule, 81 FR 674.

[77] *See id.*

margin requirements would apply, including the requirement to exchange variation margin, absent meeting the specific conditions detailed above. Other than where the two counterparties are established in the same Member State, those specific conditions involve a process of applying to the relevant Member State competent authority(ies)[78] and receiving a positive determination from either or both competent authorities[79] or upon notification to the relevant Member State competent authority(ies) and agreement of those competent authorities.[80] All exemptions are also predicated on the absence of any current or foreseen practical or legal impediment to the prompt transfer of own funds or repayment of liabilities between the counterparties[81] and on the existence of adequately sound and robust risk management practices that are consistent with the level of complexity of the derivatives transaction.[82]

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[78] RTS, Recital (37) states:
When a counterparty notifies the relevant competent authority regarding its intention to take advantage of the exemption of intragroup transactions, in order for the competent authority to decide whether the conditions for the exemption are met, the counterparty should provide a complete file including all relevant information necessary for the competent authority to complete its assessment.

[79] *See* EMIR, Article 11(6), (8), and (10).

[80] *See* EMIR, Article 11(7) and (9).

[81] *See* EMIR, Article 11(6)-(10). In addition, RTS, Recital (39) states:
In order for the exemption for intragroup transactions to be applicable, it must be certain that no legislative, regulatory, administrative or other mandatory provisions of applicable law could legally prevent the intragroup counterparties from meeting their obligations to transfer monies or repay liabilities or securities under the terms of the intragroup transactions. Similarly, there should be no operational or business practices of the intragroup counterparties or the group that could result in funds not being available to meet payment obligations as they fall due on a day-to-day basis, or in prompt electronic transfer of funds not being possible.

[82] RTS, Recital (38) states:
For a group to be deemed to have adequately sound and robust risk management procedures, a number of conditions have to be met. The group should ensure a regular monitoring of the intragroup exposures, and the timely settlement of the obligations resulting from the intragroup OTC derivative contracts should be guaranteed based on the monitoring and liquidity tools at group level that are consistent with the complexity of the intragroup transactions.

E. Methodologies for Calculating the Amounts of Initial and Variation Margin

As an overview, the methodologies for calculating initial and variation margin as agreed under the BCBS/IOSCO Framework state that the margin collected from a counterparty should (i) be consistent across entities covered by the requirements and reflect the potential future exposure (initial margin) and current exposure (variation margin) associated with the particular portfolio of non-centrally cleared derivatives, and (ii) ensure that all counterparty risk exposures are covered fully with a high degree of confidence.

With respect to the calculation of initial margin, as a minimum the BCBS/IOSCO Framework generally provides that:

- Initial margin requirements will not apply to counterparties that have less than EUR 8 billion of gross notional in outstanding derivatives.
- Initial margin may be subject to a EUR 50 million threshold applicable to a consolidated group of affiliated counterparties.
- All margin transfers between parties may be subject to a de-minimis minimum transfer amount not to exceed EUR 500,000.
- The potential future exposure of a non-centrally cleared derivative should reflect an extreme but plausible estimate of an increase in the value of the instrument that is consistent with a one-tailed 99% confidence interval over a 10-day horizon, based on historical data that incorporates a period of significant financial stress.
- The required amount of initial margin may be calculated by reference to either (i) a quantitative portfolio margin model or (ii) a standardized margin schedule.

- When initial margin is calculated by reference to an initial margin model, the period of financial stress used for calibration should be identified and applied separately for each broad asset class for which portfolio margining is allowed.

- Models may be either internally developed or sourced from the counterparties or third-party vendors but in all such cases, models must be approved by the appropriate supervisory authority.

- Quantitative initial margin models must be subject to an internal governance process that continuously assesses the value of the model's risk assessments, tests the model's assessments against realized data and experience, and validates the applicability of the model to the derivatives for which it is being used.

- An initial margin model may consider all of the derivatives that are approved for model use that are subject to a single legally enforceable netting agreement.

- Initial margin models may account for diversification, hedging, and risk offsets within well-defined asset classes such as currency/rates, equity, credit, or commodities, but not across such asset classes and provided these instruments are covered by the same legally enforceable netting agreement and are approved by the relevant supervisory authority.

- The total initial margin requirement for a portfolio consisting of multiple asset classes would be the sum of the initial margin amounts calculated for each asset class separately.

- Derivatives for which a firm faces zero counterparty risk require no initial margin to be collected and may be excluded from the initial margin calculation.

- Where a standardized initial margin schedule is appropriate, it should be computed by multiplying the gross notional size of a derivative by the standardized margin rates provided under the BCBS/IOSCO Framework and adjusting such amount by the ratio of the net current replacement cost to gross current replacement cost (NGR) pertaining to all derivatives in a legally enforceable netting set. The BCBS/IOSCO Framework provides the following standardized margin rates: [83]

Asset class	Initial margin requirement (% 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	6
Interest rate: 0–2 year duration	1
Interest rate: 2–5 year duration	2
Interest rate: 5+ year duration	4
Other	15

- For a regulated entity that is already using a schedule-based margin to satisfy requirements under its required capital regime, the appropriate supervisory authority may permit the use of the same schedule for initial margin purposes, provided that it is at least as conservative.

- The choice between model- and schedule-based initial margin calculations should be made consistently over time for all transactions within the same well defined asset class.

[83] *See* BCBS/IOSCO Framework.

- Initial margin should be collected at the outset of a transaction, and collected thereafter on a routine and consistent basis upon changes in measured potential future exposure, such as when trades are added to or subtracted from the portfolio.

- In the event that a margin dispute arises, both parties should make all necessary and appropriate efforts, including timely initiation of dispute resolution protocols, to resolve the dispute and exchange the required amount of initial margin in a timely fashion.

With respect to the calculation of variation margin, as a minimum the BCBS/IOSCO Framework generally provides that:

- The full amount necessary to fully collateralize the mark-to-market exposure of the non-centrally cleared derivatives must be exchanged.

- Variation margin should be calculated and exchanged for derivatives subject to a single, legally enforceable netting agreement with sufficient frequency (*e.g.*, daily).

- In the event that a margin dispute arises, both parties should make all necessary and appropriate efforts, including timely initiation of dispute resolution protocols, to resolve the dispute and exchange the required amount of variation margin in a timely fashion.

1. Commission Requirement for Calculation of Initial Margin

In keeping with the BCBS/IOSCO Framework described above, with respect to the calculation of initial margin, the Commission's Final Margin Rule generally provides that:

- Initial margin is intended to address potential future exposure, *i.e.*, 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).[84]

- Potential future exposure is to be an estimate of the one-tailed 99% 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 10 business days or the maturity of the swap or netting portfolio.[85]

- The required amount of initial margin may be calculated by reference to either (i) a risk-based margin model or (ii) a table-based method.[86]

- All data used to calibrate the initial margin model shall 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.[87]

- CSEs shall obtain the written approval of the Commission or a registered futures association to use a model to calculate the initial margin required.[88]

- An initial margin model may calculate initial margin for a netting portfolio of uncleared swaps covered by the same eligible master netting agreement.[89]

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[84] *See* Final Margin Rule, 81 FR 683.

[85] *See* § 23.154(b)(2)(i).

[86] *See* § 23.154(a)(1)(i) and (ii).

[87] *See* § 23.154(b)(2)(ii).

[88] *See* § 23.154(b)(1)(i).

[89] *See* § 23.154(b)(2)(v).

- An initial margin model 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 CSE validates and demonstrates the reasonableness of its process for modeling and measuring hedging benefits: commodity, credit, equity, and foreign exchange or interest rate.[90]

- 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.[91]

- 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 CSE shall calculate an amount of initial margin separately for each subset of uncleared swaps for which such relationships are explicitly recognized by the model and 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.[92]

- Where a risk-based model is not used, initial margin must be computed by multiplying the gross notional size of a derivative by the standardized margin rates

[90] *See id.*

[91] *See id.*

[92] *See* § 23.154(b)(2)(vi).

provided under § 23.154(c)(i)[93] and adjusting such amount by the ratio of the net current replacement cost to gross current replacement cost (NGR) pertaining to all derivatives under the same eligible master netting agreement.[94]

- A CSE shall not be deemed to have violated its obligation to collect or post initial margin if, *inter alia*, it makes timely initiation of dispute resolution mechanisms, including pursuant to § 23.504(b)(4).[95]

2. Commission Requirements for Calculation of Variation Margin

In keeping with the BCBS/IOSCO Framework described above, with respect to the calculation of variation margin, the Commission's Final Margin Rule generally provides that:

- Each business day, a CSE must calculate variation margin amounts for itself and for each counterparty that is an SD, MSP, or financial end user. Such variation margin amounts must be equal to the cumulative mark-to-market change in value to the CSE of each uncleared swap, adjusted for any variation margin previously collected or posted with respect to that uncleared swap.[96]

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[93] The standardized margin rates provided in § 23.154(c)(i) are, in all material respects, the same as those provided under the BCBS/IOSCO Framework. *See supra* note 83 and table in accompanying text.

[94] *See* § 23.154(c).

[95] *See* § 23.152(d)(2)(i).

[96] *See* § 23.155(a).

- Variation margin must be calculated 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.[97]

- CSEs may comply with variation margin requirements on an aggregate basis with respect to uncleared swaps that are governed by the same eligible master netting agreement.[98]

- A CSE shall not be deemed to have violated its obligation to collect or post variation margin if, *inter alia*, it makes timely initiation of dispute resolution mechanisms, including pursuant to § 23.504(b)(4).[99]

3. EU Requirements for Calculation of Initial Margin

In keeping with the BCBS/IOSCO Framework, with respect to the calculation of initial margin, the EU's margin requirements generally provide:

- Initial margin protects counterparties against potential losses which could stem from movements in the market value of the derivatives position occurring between the last exchange of variation margin before the default of a counterparty and the time that the OTC derivatives are replaced or the corresponding risk is hedged.[100] It is the collateral collected by a counterparty to cover its current and potential future exposure in the interval between the last collection of margin and the liquidation of positions or hedging of market risk following a default of the other counterparty.[101]

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[97] *See id.*

[98] *See* § 23.153(d)(1).

[99] *See* § 23.153(e)(2)(i).

[100] *See* RTS, Recital (3).

[101] *See* RTS, Article 1.

- The assumed variations in the value of the non-centrally cleared OTC derivative contracts within the netting set for the calculation of initial margins using an initial margin model shall be based on a one-tailed 99% confidence interval over a margin period of risk ("MPOR") of at least 10 days.[102]

- Counterparties shall calculate the amount of initial margin to be collected using either a standardized approach or an initial margin model or both.[103]

- Parameters used in initial margin models shall be calibrated, at least annually, based on historical data from a time period with a minimum duration of three years and a maximum duration of five years.

- The data used for calibrating the parameters of initial margin models shall include the most recent continuous period from the date on which the calibration is performed and at least 25% of those data shall be representative of a period of significant financial stress (stressed data).[104]

- Where a counterparty uses an initial margin model, that model may be developed by any of, or both, counterparties or by a third party agent.

- Where a counterparty uses an initial margin model developed by a third party agent, the counterparty shall remain responsible for ensuring that that model complies with the EU's margin rules.[105]

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[102] *See* RTS, Article 15(1).

[103] *See* RTS, Article 11(1).

[104] *See* RTS, Article 16(1) and (2).

[105] *See* RTS, Article 14.

- Initial margin models shall only include non-centrally cleared OTC derivative contracts within the same netting set.[106]

- Initial margin models may provide for diversification, hedging and risk offsets arising from the risks of the contracts within the same netting set, provided that the diversification, hedging or risk offset is only carried out within the same underlying asset class as referred to in these requirements.

- Diversification, hedging, and risk offsets may only be carried out within the following underlying asset classes: (a) interest rates, currency and inflation; (b) equity; (c) credit; (d) commodities and gold; (e) other.[107]

- In the event of a dispute over the amount of initial margin due, counterparties shall provide at least the part of the initial margin amount that is not being disputed within the same business day of the calculation date determined in accordance with Article 9(3).[108]

4. EU Requirements for Calculation of Variation Margin

In keeping with the BCBS/IOSCO Framework, with respect to the calculation of variation margin, the EU's margin requirements generally provide:

- FCs and NFC+s shall mark-to-market on a daily basis the value of outstanding contracts. Where market conditions prevent marking-to-market, reliable and prudent marking-to-model shall be used.[109]

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[106] *See* RTS, Article 17(1) and (2).

[107] *See* RTS, Article 17(1) and (2).

[108] *See* RTS, Article 13(3).

[109] *See* EMIR, Article 11(2); RTS, Article 9.

- The amount of variation margin to be collected by a counterparty shall be the aggregation of the values calculated for purposes of variation margin of all contracts in the netting set, minus the value of all variation margin previously collected, minus the net value of each contract in the netting set at the point of entry into the contract, and plus the value of all variation margin previously posted.[110]

- In the event of a dispute over the amount of variation margin due, counterparties shall provide at least the part of the variation margin amount that is not being disputed.[111]

5. Commission Determination

Based on the foregoing and the representations of the applicant, the Commission has determined that the amounts of initial and variation margin calculated under the methodologies required under the EU's margin rules would be similar to those calculated under the methodologies required under the Final Margin Rule. Specifically, under the Final Margin Rule and the EU's margin rules:

- The definitions of initial and variation margin are similar, including the description of potential future exposure agreed under the BCBS/IOSCO Framework;

- Margin models and/or a standardized margin schedule may be used to calculate initial margin;

- Criteria for historical data to be used in initial margin models is similar;

- Eligibility for netting is similar;

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[110] *See* EMIR, Article 11(2); RTS, Article 10.

[111] *See* RTS, Article 12(3).

- Correlations may be recognized within broad risk categories, but not across such risk categories;
- The required method of calculating initial margin using standardized margin rates is essentially identical; and
- The proscribed standardized margin rates are essentially identical.

Accordingly, the Commission finds that the methodologies for calculating the amounts of initial and variation margin for non-centrally cleared OTC derivatives under the laws of the EU are comparable in outcome to those of the Final Margin Rule.

F. Process and Standards for Approving Margin Models

Pursuant to the BCBS/IOSCO Framework, initial margin models may be either internally developed or sourced from counterparties or third-party vendors but in all such cases, models must be approved by the appropriate supervisory authority.[112]

1. Commission Requirement for Margin Model Approval

In keeping with the BCBS/IOSCO Framework, the Final Margin Rule generally requires:

- CSEs shall obtain the written approval of the Commission or a registered futures association to use a model to calculate the initial margin required.[113]
- The Commission or a registered futures association will approve models that demonstrate satisfaction of all of the requirements for an initial margin model set forth

[112] *See* BCBS/IOSCO Framework Requirement 3.3.

[113] *See* § 23.154(b)(1)(i).

above in Section IV(E)(1), in addition to the requirements for annual review;[114] control, oversight, and validation mechanisms;[115] documentation;[116] and escalation procedures.[117]

- CSEs must notify the Commission and the registered futures association in writing 60 days prior to extending the use of an initial margin model to an additional product type; making any change to the model that would result in a material change in the CSE's assessment of initial margin requirements; or making any material change to modeling assumptions.

- The Commission or the registered futures association may rescind its approval, or may impose additional conditions or requirements if the Commission or the registered futures association determines, in its discretion, that a model no longer complies with the requirements for an initial margin model summarized above in Section IV(E)(1).

2. EU Requirement for Approval of Margin Models

The EU's margin rules generally require:

- Upon request, counterparties using a non-standardized initial margin model shall provide the competent authorities with any documentation relating to the risk management procedures relating to such model at any time.[118]

3. Commission Determination

[114] *See* § 23.154(b)(4), discussed further below.

[115] *See* § 23.154(b)(5), discussed further below.

[116] *See* § 23.154(b)(6), discussed further below.

[117] *See* § 23.154(b)(7), discussed further below.

[118] *See* RTS, Article 2(6).

Based on the foregoing and the representations of the applicant, the Commission has determined that the EU margin rules' requirement that an FC/NFC+ make documentation supporting an initial model available to a competent authority at any time is comparable in outcome to, the regulatory approval requirements of the Final Margin Rule. While the Commission recognizes that keeping documents open to regulatory review is not the same as requiring specific pre-approval from a regulator, the EC has represented that competent authorities within the Member States responsible for supervising FCs and, where applicable NFC+s, as part of their ongoing prudential regulation and supervision will enforce applicable legislation and control whether the models adopted by these entities comply with the requirements under the EU margin rules. Furthermore, Article 12 of EMIR grants the competent authorities in each Member State the authority to impose fines in case of infringement of the rules promulgated under EMIR, such as the RTS.[119] Such infringement could include an FC's or NFC+'s violations of the provisions under Section 4 of the RTS that establish the general requirements for initial margin models.[120]

G. Timing and Manner for Collection or Payment of Initial and Variation Margin

[119] *See* RTS, Article 40.

[120] The applicant noted that, in a November 23, 2016 report to the European Parliament and the Council on areas where further action is necessary to ensure that the objectives of EMIR are fulfilled "in a more appropriate, efficient and effective manner," on the issue of margin model approval, the EC stated:
[W]ith respect to *non-cleared* transactions, some respondents, notably financial institutions, noted the absence of a clear mandate for initial margin models to be endorsed by authorities, which could lead to uncertainty among market participants as to whether their calculations are considered by authorities to be fully compliant with regulations. *A mandate for initial margin models to be endorsed by authorities could promote certainty for market participants and authorities alike.*
See November 23, 2016 Report from the EC to the European Parliament and the Council under Article 85(1) of EMIR on OTC Derivatives, Central Counterparties and Trade Repositories, section 4.1.2 (emphasis included), at http://ec.europa.eu/finance/financial-markets/docs/derivatives/161123-report_en.pdf.

1. Commission Requirement for Timing and Manner for Collection or Payment of Initial and Variation Margin

With respect to the timing and manner for collection or posting of initial margin, the Final Margin Rule generally provides that:

- Where a CSE is required to collect initial margin, it must be collected on or before the business day after execution of an uncleared swap, and thereafter the CSE must continue to hold initial margin in an amount equal to or greater than the required initial margin amount as re-calculated each business day until such uncleared swap is terminated or expires.

- Where a CSE is required to post initial margin, it must be posted on or before the business day after execution of an uncleared swap, and thereafter the CSE must continue to post initial margin in an amount equal to or greater than the required initial margin amount as re-calculated each business day until such uncleared swap is terminated or expires.

- Required initial margin amounts must be posted and collected by CSEs on a gross basis (*i.e.*, amounts to be posted may not be set-off against amounts to be collected from the same counterparty).

With respect to the timing and manner for collection or posting of variation margin, the Final Margin Rule generally provides that:

- Where a CSE is required to collect variation margin, it must be collected on or before the business day after execution of an uncleared swap, and thereafter the CSE

must continue to collect the required variation margin amount, if any, each business day as re-calculated each business day until such uncleared swap is terminated or expires.[121]

- Where a CSE is required to post variation margin, it must be posted on or before the business day after execution of an uncleared swap, and thereafter the CSE must continue to post the required variation margin amount, if any, each business day as re-calculated each business day until such uncleared swap is terminated or expires.[122]

With respect to both initial and variation margin, a CSE shall not be deemed to have violated its obligation to collect or post margin if, *inter alia*, it makes timely initiation of dispute resolution mechanisms, including pursuant to § 23.504(b)(4).[123]

2. EU Requirements for Timing and Manner for Collection of Initial and Variation Margin

With respect to the timing and manner for collection or posting of initial margin, the EU's margin rules generally provide that:

- Counterparties shall calculate initial margin no later than the business day following one of these events: (a) where a new non-centrally cleared OTC derivative contract is executed or added to the netting set; (b) where an existing non-centrally cleared OTC derivative contract expires or is removed from the netting set; (c) where an existing non-centrally cleared OTC derivative contract triggers a payment or a delivery other than the posting and collecting of margins; (d) where the initial margin is calculated in accordance with the standardized approach and an existing contract is reclassified in

[121] *See* § 23.153(a).

[122] *See* § 23.153(b).

[123] *See* § 23.153(e)(2)(i).

terms of the asset category referred to by the RTS as a result of reduced time to maturity; (e) where no calculation has been performed in the preceding 10 business days.[124]

- The posting counterparty shall provide the initial margin within the same business day of the calculation date.[125]

- Where two counterparties are located in the same time-zone, the calculation shall be based on the netting set of the previous business day.[126]

- Where two counterparties are not located in the same time-zone, the calculation shall be based on the transactions in the netting set which are entered into before 16:00 hours of the previous business day of the time-zone where it is first 16:00 hours.[127]

- In the event of a dispute over the amount of initial margin due, counterparties shall provide at least the part of the initial margin amount that is not being disputed within the same business day of the calculation date.[128]

With respect to the timing and manner for collection or posting of variation margin, the EU's margin rules generally provide that:

- Counterparties shall calculate variation margin at least on a daily basis.[129]

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[124] *See* RTS, Article 9(2).

[125] *See* RTS, Article 13(2).

[126] *See* RTS, Article 9(3)(a).

[127] *See* RTS, Article 9(3)(b).

[128] *See* RTS, Article 13(3).

[129] *See* RTS, Article 9(1).

- The posting counterparty shall provide the variation margin as follows: (a) within the same business day of the calculation date; (b) where certain conditions are met,[130] within two business days of the calculation date.[131]

- In the event of a dispute over the amount of variation margin due, counterparties shall provide at least the part of the variation margin amount that is not being disputed.[132]

3. Commission Determination

Having compared the EU's margin requirements applicable to the timing and manner of collection and payment of initial and variation margin to the Commission's corresponding margin requirements, the Commission finds that the EU's margin requirements are, despite apparent differences in certain respects, comparable in outcome.

Under the Final Margin Rule, where initial margin is required, a CSE must calculate the amount of initial margin each business day. The EU's margin rules only

[130] The provision of variation margin within two business of the calculation date may only be applied to the following:
(a) netting sets comprising derivative contracts not subject to initial margin requirements in accordance with this Regulation, where the posting counterparty has provided, at or before the calculation date of the variation margin, an advance amount of eligible collateral calculated in the same manner as that applicable to initial margins in accordance with Article 15, for which the collecting counterparty has used a margin period of risk (MPOR) at least equal to the number of days in between and including the calculation date and the collection date; (b) netting sets comprising contracts subject to initial margin requirements in accordance with this Regulation, where the initial margin has been adjusted in one of the following ways: (i) by increasing the MPOR referred to in Article 15(2) by the number of days in between, and including, the calculation date determined in accordance with Article 9(3) and the collection date determined in accordance with paragraph 1 of this Article; (ii) by increasing the initial margin calculated in accordance with the standardised approach referred to in Article 11 using an appropriate methodology taking into account a MPOR that is increased by the number of days in between, and including, the calculation date determined in accordance with Article 9(3) and the collection date determined in accordance with paragraph 2 of this Article. For the purposes of point (a), in case no mechanism for segregation is in place between the two counterparties, those counterparties may offset the amounts to be provided.

[131] *See* RTS, Article 12(1).

[132] *See* RTS, Article 12(3).

require initial margin to be calculated after certain events, including the addition or removal of a non-centrally cleared OTC derivative from the netting set or at least within 10 days after the last initial margin calculation. While this is different from the Final Margin Rule's requirement that the amount of initial margin be calculated each business day, the EC has explained that the more sophisticated counterparties subject to the EU margin rules actively operate in non-centrally cleared OTC derivatives to the point where the RTS requirement to recalculate whenever there is a change to the netting set will in practice require these types of counterparties to recalculate daily. Because of this, the EC views the 10-day allowance under Article 9(2)(e) of the RTS as a backstop only and one that is likely to be exercised only in the case of a static portfolio. The Commission believes that as a result of these entities still exchanging variation margin, and thereby eliminating current exposure, this difference will be mitigated.

With respect to the timing of collecting/posting margin, the Final Margin Rule requires CSEs to collect/post any required margin amount within one business day of calculation which, under the Final Margin Rule, must occur daily. In contrast, the EU's margin rules allow for a variation margin posting date within two business days of the calculation date (T+2) when certain conditions are met.[133] As explained in the Recitals to the RTS, additional time for posting of variation margin is allowed only where compensated by an adjustment to initial margin by an adequate recalculation of MPOR.[134] Where initial margin is required, an adequate recalculation of MPOR under the RTS would occur by increasing the MPOR by the number of days in between, and

[133] *See* RTS, Article 12(2).

[134] *See* RTS, Recital (20).

including, the calculation and collection dates or by increasing the initial margin calculated with the standardized approach taking into account a MPOR increased by the number of days in between, and including, the calculation and collection dates.[135] Where no initial margin requirements apply, additional time is permitted for posting of variation margin if the posting counterparty has provided, at or before the variation margin calculation date, an advance amount of eligible collateral calculated in the same manner as required for initial margin with an MPOR at least equal to the number of days in between, and including, the calculation and collection dates.[136]

While the RTS conditions to a delay in the exchange of variation margin do not make the EU's rule in this area the same as the Final Margin Rule, they do serve to mitigate the potential risks, as described above, by increasing the initial margin's MPOR by the corresponding number of days associated with a delay in the exchange of variation margin. Furthermore, although the EU's allowance for a delay of up to 10 days to recalculate initial margin is not the same as the Final Margin Rule's daily recalculation requirement, as detailed above, the EC has represented that, in practice, it expects the most sophisticated counterparties subject to the EU margin rules to recalculate initial margin on a daily basis. Thus, the Commission finds that the requirements of the EU margin rules with respect to the timing and manner for collection or payment of initial and variation margin are comparable in outcome to the Final Margin Rule.

H. Margin Threshold Levels or Amounts

[135] *See* RTS, Article 12(2)(b).

[136] *See* RTS, Recital (20) and Article 12(2)(a).

The BCBS/IOSCO Framework provides that initial margin could be subject to a threshold not to exceed EUR 50 million. The threshold is applied at the level of the consolidated group to which the threshold is being extended and is based on all non-centrally cleared derivatives between the two consolidated groups.

Similarly, to alleviate operational burdens associated with the transfer of small amounts of margin, the BCBS/IOSCO Framework provides that all margin transfers between parties may be subject to a de-minimis minimum transfer amount not to exceed EUR 500,000.

1. Commission Requirement for Margin Threshold Levels or Amounts

In keeping with the BCBS/IOSCO Framework, with respect to margin threshold levels or amounts the Final Margin Rule generally provides that:

- CSEs may agree with their counterparties that initial margin may be subject to a threshold of no more than $50 million applicable to a consolidated group of affiliated counterparties.[137]
- CSEs are not required to collect or to post initial or variation margin with a counterparty until the combined amount of initial margin and variation margin to be collected or posted is greater than $500,000 (i.e., a minimum transfer amount).[138]

2. EU Requirement for Margin Threshold Levels or Amounts

In keeping with the BCBS/IOSCO Framework, with respect to margin threshold levels or amounts, the EU's margin requirements generally provide that:

[137] *See* § 23.154(a)(3) and definition of "initial margin threshold" in § 23.151.

[138] *See* § 23.152(b)(3).

- Counterparties may provide in their risk management procedures that initial margin collected is reduced by an amount up to EUR 50 million where neither counterparty belongs to any group or the counterparties are part of different groups; or EUR 10 million where both counterparties belong to the same group.[139]

- Counterparties may provide in their risk management procedures that no collateral is collected from a counterparty where the amount due from the last collection of collateral is equal to or lower than the amount agreed by the counterparties. The minimum transfer amount shall not exceed EUR 500,000 or the equivalent amount in another currency.[140]

3. Commission Determination

Based on the foregoing and the representations of the applicant, the Commission has determined that the EU requirements for margin threshold levels or amounts, in the case of FCs and NFC+s, are comparable in outcome to those required by the Final Margin Rule, in the case of CSEs.

The Commission notes that at current exchange rates, EUR 50 million is approximately $59 million, while EUR 500,000 is approximately $588,000. Although these amounts are greater than those permitted by the Final Margin Rule, the Commission recognizes that exchange rates will fluctuate over time and thus the Commission finds that such requirements under the laws of the EU are comparable in outcome to those of the Final Margin Rule.

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[139] *See* RTS, Article 29(1).

[140] *See* RTS, Article 25(1).

I. Risk Management Controls for the Calculation of Initial and Variation Margin

1. Commission Requirement for Risk Management Controls for the Calculation of Initial and Variation Margin

With respect to risk management controls for the calculation of initial margin, the Final Margin Rule generally provides that:

- CSEs are required to have a risk management unit pursuant to § 23.600(c)(4). Such risk management unit must include a risk control unit tasked with validation of a CSE's initial margin model prior to implementation and on an ongoing basis, including an evaluation of the conceptual soundness of the initial margin model, an ongoing monitoring process that includes verification of processes and benchmarking by comparing the CSE's initial margin model outputs (estimation of initial margin) with relevant alternative internal and external data sources or estimation techniques, and an outcomes analysis process that includes back testing the model.[141]

- In accordance with § 23.600(e)(2), CSEs must 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 CSE's initial margin requirements under this part.[142]

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[141] *See* § 23.154(b)(5).

[142] *See* § 23.154(b)(5)(iv).

- At least annually, such internal audit function shall report its findings to the CSE's governing body, senior management, and chief compliance officer.[143]

With respect to risk management controls for the calculation of variation margin, the Final Margin Rule generally provides that:

- CSEs must maintain documentation setting forth the variation methodology with sufficient specificity to allow a counterparty, the Commission, a registered futures association, and any applicable prudential regulator to calculate a reasonable approximation of the margin requirement independently.

- CSEs must evaluate the reliability of its data sources at least annually, and make adjustments, as appropriate.

- CSEs, upon request of the Commission or a registered futures association, must provide further data or analysis concerning the variation methodology or a data source, including: (a) the manner in which the methodology meets the requirements of the Final Margin Rule; (b) a description of the mechanics of the methodology; (c) the conceptual basis of the methodology; (d) the empirical support for the methodology; and (e) the empirical support for the assessment of the data sources.

2. EU Requirement for Risk Management Controls for the Calculation of Initial and Variation Margin

With respect to risk management controls for the calculation of initial margin, the EU's margin requirements generally provide that:

- Counterparties shall establish an internal governance process to assess the appropriateness of the initial margin model on a continuous basis, including all of the

[143] *See* § 23.154(b)(5)(iv).

following: (a) an initial validation of the model by suitably qualified persons who are independent from the persons developing the model; (b) a follow up validation whenever a significant change is made to the initial margin model and at least annually; and (c) a regular audit process to assess the following: (i) the integrity and reliability of the data sources; (ii) the management information system used to run the model; (iii) the accuracy and completeness of data used; (iv) the accuracy and appropriateness of volatility and correlation assumptions.[144]

- The documentation of the risk management procedures relating to the initial margin model shall meet all of the following conditions: (a) it shall allow a knowledgeable third-party to understand the design and operational detail of the initial margin model; (b) it shall contain the key assumptions and the limitations of the initial margin model; (c) it shall define the circumstances under which the assumptions of the initial margin model are no longer valid.[145]

- Counterparties shall document all changes to the initial margin model. That documentation shall also detail the results of the validations carried out after those changes.[146]

3. Commission Determination

Based on the foregoing and the representations of the applicant, the Commission has determined that the EU requirements applicable to FCs and NFC+s pertaining to risk management controls for the calculation of initial and variation margin are substantially

[144] *See* RTS, Article 1.

[145] *See* RTS, Article 18(2).

[146] *See* RTS, Article 18(3).

the same as the corresponding requirements under the Final Margin Rule. Specifically, the Commission finds that under both the EU's requirements and the Final Margin Rule, a CSE is required to establish a unit that is tasked with comprehensively managing the entity's use of an initial margin model, including establishing controls and testing procedures. Accordingly, the Commission finds that the EU's requirements pertaining to risk management controls over the use of initial margin models are comparable in outcome to the controls required by the Final Margin Rule.

J. Eligible Collateral for Initial and Variation Margin

As explained in the BCBS/IOSCO Framework, to ensure that counterparties can liquidate assets held as initial and variation margin in a reasonable amount of time to generate proceeds that could sufficiently protect collecting entities from losses on non-centrally cleared derivatives in the event of a counterparty default, assets collected as collateral for initial and variation margin purposes should be highly liquid and should, after accounting for an appropriate haircut, be able to hold their value in a time of financial stress. Such a set of eligible collateral should take into account that assets which are liquid in normal market conditions may rapidly become illiquid in times of financial stress. In addition to having good liquidity, eligible collateral should not be exposed to excessive credit, market and FX risk (including through differences between the currency of the collateral asset and the currency of settlement). To the extent that the value of the collateral is exposed to these risks, appropriately risk-sensitive haircuts should be applied. More importantly, the value of the collateral should not exhibit a significant correlation with the creditworthiness of the counterparty or the value of the underlying non-centrally cleared derivatives portfolio in such a way that would

undermine the effectiveness of the protection offered by the margin collected. Accordingly, securities issued by the counterparty or its related entities should not be accepted as collateral. Accepted collateral should also be reasonably diversified.

1. Commission Requirement for Eligible Collateral for Initial and Variation Margin

With respect to eligible collateral that may be collected or posted to satisfy an initial margin obligation, the Final Margin Rule generally provides that CSEs may collect or post:[147]

- Cash denominated in a major currency, being 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); any other currency designated by the Commission; or any currency of settlement for a particular uncleared swap.

- 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.

- 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.

- 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

[147] *See* § 23.156(a)(1).

higher than a 20 percent risk weight under the capital rules applicable to SDs subject to regulation by a prudential regulator.

- 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.

- 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 as defined in § 23.151.

- Other publicly-traded debt that has been deemed acceptable as initial margin by a prudential regulator as defined in § 23.151.

- A publicly-traded common equity security that is included in 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 an index that a CSE'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.

- 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 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 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% risk weight under the capital rules applicable to SDs subject to regulation by a Prudential Regulator, and immediately-available cash funds denominated in the same currency; and 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.

- Gold.
- A CSE may not collect or post as initial margin any asset that is a security issued by: the CSE or a margin affiliate of the CSE (in the case of posting) or the counterparty or any margin affiliate of the counterparty (in the case of collection); 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 CFR 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 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).[148]

[148] *See* § 23.156(a)(2).

- The value of any eligible collateral collected or posted to satisfy initial margin requirements must be reduced by the following haircuts: an 8% 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 an eligible master netting agreement; and the discounts set forth in the following table:[149]

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): Residual maturity less than one-year	0.5
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

With respect to eligible collateral that may be collected or posted to satisfy a variation margin obligation, the Final Margin Rule generally provides that CSEs may collect or post:[150]

[149] *See* § 23.156(a)(3).

[150] *See* § 23.156(b)(1).

- With respect to uncleared swaps with an SD or MSP, only immediately available cash funds that are denominated in: U.S. dollars, another major currency (as defined in § 23.151), or the currency of settlement of the uncleared swap.

- With respect to any other uncleared swaps for which a CSE is required to collect or post variation margin, any asset that is eligible to be posted or collected as initial margin, as described above.

- The value of any eligible collateral collected or posted to satisfy variation margin requirements must be reduced by the same haircuts applicable to initial margin described above.[151]

Finally, CSEs must monitor the value and eligibility of collateral collected and posted:[152]

- CSEs must monitor the market value and eligibility of all collateral collected and posted, and, to the extent that the market value of such collateral has declined, the CSE must 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 collateral is no longer eligible, CSEs must promptly collect or post sufficient eligible replacement collateral to comply with the margin requirements of §§ 23.150 through 23.161.

2. EU Requirement for Eligible Collateral for Initial and Variation Margin

[151] *See* § 23.156(b)(2).

[152] *See* § 23.156(c).

With respect to eligible collateral that may be collected to satisfy an initial or variation margin obligation, the EU's margin requirements generally provide that counterparties may collect:[153]

- Cash in the form of money credited to an account in any currency, or similar claims for the repayment of money, such as money market deposits.
- Gold.
- Debt securities issued by Member States' central governments or central banks.
- Debt securities issued by Member States' regional governments or local authorities whose exposures are treated as exposures to the central government of that Member State in accordance with Article 115(2) of Regulation (EU) No 575/2013.
- Debt securities issued by Member States' public sector entities whose exposures are treated as exposures to the central government, regional government or local authority of that Member State in accordance with Article 116(4) of Regulation (EU) No 575/2013.
- Debt securities issued by multilateral development banks listed in Article 117(2) of Regulation (EU) No 575/2013.
- Debt securities issued by the international organizations listed in Article 118 of Regulation (EU) No 575/2013.
- Debt securities issued by third countries' governments or central banks.

[153] *See* RTS, Article 4.

- Where the assets are not issued by the posting counterparty, not issued by entities that are part of the same group as the posting counterparty, or not otherwise subject to any wrong way risk, a counterparty may collect:
    - Debt securities issued by Member States' regional governments or local authorities whose exposures are not treated as exposures to the central government of that Member State;
    - Debt securities issued by Member States' public sector entities whose exposures are treated as exposures to the central government, regional government, or local authority of that Member State;
    - Debt securities issued by third countries' regional governments or local authorities whose exposures are treated as exposures to the central government, regional government, or local authority of that third country;
    - Debt securities issued by third countries' regional governments or local authorities whose exposures are not treated as exposures to the central government, regional government, or local authority of that third country;
    - Debt securities issued by credit institutions or investment firms including bonds referred to in Article 52(4) of Directive 2009/65/EC of the European Parliament and of the Council;
    - Corporate bonds;
    - The most senior tranche of a securitization, as defined in Article 4(61) of Regulation (EU) No 575/2013, that is not a re-securitization as defined in Article 4(63) of that Regulation;

- Convertible bonds provided that they can be converted only into equities which are included in an index specified pursuant to point (a) of Article 197 (8) of Regulation (EU) No 575/2013;
- Equities included in an index specified pursuant to point (a) of Article 197(8) of Regulation (EU) No 575/2013;
- A counterparty may only use units or shares in undertakings for collective investments in transferable securities (UCITS) as eligible collateral where all the following conditions are met: (a) the units or shares have a daily public price quote; (b) the UCITS are limited to investing in assets that are eligible in accordance with Article 4(1); (c) the UCITS meet the criteria laid down in Article 132(3) of Regulation (EU) No 575/2013. For the purposes of point (b), UCITS may use derivative instruments to hedge the risks arising from the assets in which they invest. In addition, where a UCITS invests in shares or units of other UCITS, these conditions shall also apply to those UCITS.[154]
- Where a UCITS or any of its underlying UCITS do not only invest in assets that are eligible collateral under the RTS, only the value of the unit or share of the UCITS that represents investment in eligible assets may be used as eligible collateral.[155]
- Where non-eligible assets of a UCITS can have a negative value, the value of the unit or share of the UCITS that may be used as eligible collateral

[154] *See* RTS, Article 5(1).

[155] *See* RTS, Article 5(2).

shall be determined by deducting the maximum negative value of the non-eligible assets from the value of eligible assets.[156]

- Counterparties must assess the credit quality of certain asset classes.[157]
- Counterparties shall adjust the value of collected collateral in accordance with either a methodology prescribed by the RTS[158] or a methodology using their own volatility estimates.[159]
- There are certain concentration limits for collateral collected as initial margin.[160]

If a counterparty chooses to not use its own volatility estimates, the value of any eligible collateral collected or posted to satisfy initial margin requirements must be reduced by the following haircuts:[161]

Cash in same currency as swap obligation	0.0
Debt securities issued by entities describe in Article 4(1)(c) to (e) and (h) to (k): Residual maturity less than one-year	0.5
Debt securities issued by entities describe in Article 4(1)(c) to (e) and (h) to (k): Residual maturity between one and five years	2.0
Debt securities issued by entities describe in Article 4(1)(c) to (e) and (h) to (k): Residual maturity greater than five years	4.0
Debt securities issued by entities describe in Article 4(1)(f), (g) and (l) to (n): Residual maturity less than one-year	1.0
Debt securities issued by entities describe in Article 4(1)(f), (g) and (l) to (n): Residual maturity between one and five years	4.0
Debt securities issued by entities describe in Article 4(1)(f), (g) and (l) to (n): Residual maturity greater than five years	8.0

[156] *See* RTS, Article 5(3).

[157] *See* RTS, Article 6.

[158] *See* RTS, Annex III.

[159] *See* RTS, Article 21.

[160] *See* RTS, Article 8.

[161] *See* RTS, Annex II.

Securitization positions meeting the criteria in Article 4(1)(o): Residual maturity of less than one year	2.0
Securitization positions meeting the criteria in Article 4(1)(o): Residual maturity between one and five years	8.0
Securitization positions meeting the criteria in Article 4(1)(o): Residual maturity of more than five years	16.0
Equities included in main indices, bonds convertible to equities in main indices, and gold	15.0

In addition to the foregoing, under the EU's margin requirements, for the purpose of exchanging initial margin, all cash and non-cash collateral posted in a currency other than the currency in which the payments in case of early termination or default have to be made in accordance with the single derivative contract, the relevant exchange of collateral agreement or the relevant credit support annex ("termination currency"). Each of the counterparties may choose a different termination currency. Where the agreement does not identify a termination currency, the haircut shall apply to the market value of all the assets posted as collateral.[162]

3. Commission Determination

Based on the foregoing and the representations of the applicant, the Commission finds that the EU's requirements pertaining to assets eligible for posting or collecting by FCs and NFC+s as collateral for non-centrally cleared OTC derivatives, while different than the Final Margin Rule in some respects, are comparable in outcome to the Final Margin Rule.

For example, under the EU margin regime, cash in the form of a claim for the repayment of money, such as money market deposits, is eligible collateral while under the Final Margin Rule it is not. However, although the EU margin regime and Final

[162] *See* RTS, Annex II, Table 3.

Margin Rule take different approaches on this point, the Commission did recognize the need for flexibility provided to counterparties by money market funds when it allowed for the use of 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.[163]

The EU's requirements are also different with respect to the eligible collateral for variation margin for non-centrally cleared OTC derivatives between FC/NFC+s that are CSEs and FC/NFC+s that are SDs and MSPs (including other CSEs). For uncleared swaps with an SD or MSP, the Final Margin Rule only permits variation margin to be posted or collected as immediately available cash funds that are denominated in U.S. dollars, another major currency (as defined in § 23.151), or the currency of settlement of the uncleared swap, while the EU's margin requirements would permit any form of eligible collateral (as described above). The Commission did state in the Final Margin Rule, however, that requiring variation margin to be posted or collected as immediately available cash funds is "consistent with regulatory and industry initiatives to improve standardization and efficiency in the OTC swaps market."[164] Thus, in outcome, an SD or MSP that is also subject to the EU margin rules likely would, in the normal course of business, be exchanging variation margin in immediately available cash funds.

Other differences concern corporate bonds, the most senior tranche of a securitization, and convertible bonds that can be converted only into equities listed on

[163] *See* Final Margin Rule, 81 FR 636, 665.

[164] *See id.* at 668.

specific indexes, all of which are allowed under the EU margin rules but not under the Final Margin Rule. However, the EU margin rules do address the inherent risk posed by these assets by including additional safeguards when using these types of collateral. Regarding corporate bonds and convertible bonds, a counterparty subject to the EU margin rules must assess the credit quality of the assets using a specified internal rating or a credit quality assessment issued by a recognized External Credit Assessment Institution ("ECAI").[165] Regarding the most senior tranche of a securitization, a counterparty must use an ECAI's credit quality assessment to assess the tranche's credit quality.[166]

The EU's margin rules on eligible collateral also differ from the Final Margin Rule in ways that make the EU rules more stringent than the Final Margin Rule. For example, the EU margin rules require a larger haircut than the Final Margin Rule on government, central bank, and corporate debt where a credit quality assessment, as required under Article of the RTS, indicates low credit quality for such debt.[167] In addition, the EU's margin rules impose concentration limits for initial margin.[168]

While not identical, the Commission finds that the forms of eligible collateral for initial and variation margin under the laws of the EU provide protections that are comparable in outcome, as explained above, to the forms of eligible collateral mandated by the Final Margin Rule. Specifically, the Commission finds that the EU's margin regime ensures that assets collected as collateral for initial and variation margin purposes

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[165] *See* RTS, Article 6(1).

[166] *See* RTS, Article 6(2).

[167] *See* RTS, Articles 6 and 7.

[168] *See* RTS, Article 8.

are highly liquid and able to hold their value in a time of financial stress. Because under the EU's margin regime a non-defaulting party would be able to liquidate assets held as initial and variation margin in a reasonable amount of time to generate proceeds that could sufficiently protect collecting entities from losses on uncleared swaps in the event of a counterparty default, the Commission finds the EU's margin regime with respect to the forms of eligible collateral for initial and variation margin for uncleared swaps is comparable in outcome to the Final Margin Rule.

K. Requirements for Custodial Arrangements, Segregation, and Rehypothecation

As explained in the BCBS/IOSCO Framework, the exchange of initial margin on a net basis may be insufficient to protect two market participants with large gross derivatives exposures to each other in the case of one firm's failure. Thus, the gross initial margin between such firms should be exchanged.[169]

Further, initial margin collected should be held in such a way as to ensure that (i) the margin collected is immediately available to the collecting party in the event of the counterparty's default, and (ii) the collected margin must be subject to arrangements that protect the posting party to the extent possible under applicable law in the event that the collecting party enters bankruptcy.[170]

1. Commission Requirement for Custodial Arrangements, Segregation, and Rehypothecation

[169] *See* BCBS/IOSCO Framework, Key principle 5.

[170] *See id.*

In keeping with the principles set forth in the BCBS/IOSCO Framework, with respect to custodial arrangements, segregation, and rehypothecation, the Final Margin Rule generally requires that:

- All assets posted by or collected by CSEs as initial margin must be held by one or more custodians that are not the CSE, the counterparty, or margin affiliates of the CSE or the counterparty.[171]

- CSEs must enter into an agreement with each custodian holding initial margin collateral that:

    - 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;
    - May permit the custodian to hold cash collateral in a general deposit account with the custodian if the funds in the account are used to purchase an asset that qualifies as eligible collateral (other than equities, investment vehicle securities, or gold), such asset is held in compliance with § 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; and
    - 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.[172]

[171] *See* § 23.157(a) and (b).

- A posting party may substitute any form of eligible collateral for posted collateral held as initial margin.[173]

- A posting party may direct reinvestment of posted collateral held as initial margin in any form of eligible collateral.[174]

- Collateral that is collected or posted as variation margin is not required to be held by a third party custodian and is not subject to restrictions on rehypothecation, repledging, or reuse.[175]

2. EU Requirement for Custodial Arrangements, Segregation, and Rehypothecation

In keeping with the principles set forth in the BCBS/IOSCO Framework, with respect to custodial arrangements, segregation, and rehypothecation, the EU's margin rules generally require that:

- Cash collected as initial margin must be maintained in cash accounts at central banks or credit institutions which fulfill all of the following conditions: (i) they are authorized in accordance with Directive 2013/36/EU or are authorized in a third country whose supervisory and regulatory arrangements have been found to be equivalent in accordance with Article 142(2) of Regulation (EU) No 575/2013; and (ii) they are neither the posting nor the collecting counterparties, nor part of the same group as either of the counterparties.[176]

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[172] *See* § 23.157(c)(1) and (2).

[173] *See* § 23.157(c)(3).

[174] *See id.*

[175] *See* Final Margin Rule, 81 FR at 672.

[176] *See* RTS, Article 19(1)(e).

- Any collateral posted as initial or variation margin may be substituted by alternative collateral where all of the following conditions are met: (a) the substitution is made in accordance with the terms of the collateral agreement between the counterparties; (b) the alternative collateral is eligible under the RTS; (c) the value of the alternative collateral is sufficient to meet all margin requirements after applying any relevant haircut.[177]

- Initial margin shall be protected from the default or insolvency of the collecting counterparty by segregating it in either or both of the following ways: (a) on the books and records of a third party-holder or custodian; (b) via other legally binding arrangements.[178]

- Counterparties shall ensure that non-cash collateral exchanged as initial margin is segregated as follows: (a) where collateral is held by the collecting counterparty on a proprietary basis, it shall be segregated from the rest of the proprietary assets of the collecting counterparty; (b) where collateral is held by the posting counterparty on a non-proprietary basis, it shall be segregated from the rest of the proprietary assets of the posting counterparty; (c) where collateral is held on the books and records of a custodian or other third party holder, it shall be segregated from the proprietary assets of that third-party holder or custodian.[179]

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177 *See* RTS, Article 19(2).

178 *See* RTS, Article 19(3).

179 *See* RTS, Article 19(5).

- The collecting counterparty shall not rehypothecate, repledge nor otherwise reuse the collateral collected as initial margin.[180]

- A third party holder may use the initial margin received in cash for reinvestment purposes.[181]

3. Commission Determination

The Commission notes that in one respect, the EU's margin requirements with respect to custodial arrangements are less stringent than those of the Final Margin Rule. Under the Final Margin Rule, all assets posted by or collected by CSEs as initial margin must be held by one or more custodians that are not the CSE, the counterparty, or margin affiliates of the CSE or the counterparty.[182] The EU's margin rules do not prohibit an FC or NFC+ from using an affiliated entity as custodian to hold initial margin other than cash collected from counterparties.

However, the EC has highlighted in its application that Article 19(3) of the RTS, which governs how initial margin must be held, leads with the requirement that "initial margin shall be protected from the default or insolvency of the collecting counterparty." As the applicant further represented, the EC and the European Supervisory Authorities favor the use of third-party holders or custodians for non-cash collateral but recognize through Article 19(3)(b) of the RTS that the legal framework in the EU and, in particular, the Financial Collateral Directive,[183] allows Member States to authorize other specific

[180] *See* RTS, Article 20(1).

[181] *See* RTS, Article 20(2).

[182] *See* § 23.157(a) and (b).

[183] *See* http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02002L0047-20140702&from=EN.

legally binding arrangements with equivalent finality and protection. An example, according to the applicant, would be a third-country trust bank that, while not necessarily recognized as a custodian in the EU or individual Member State, may offer equivalent collateral protection, both legally and operationally.

To further encourage the use of arrangements that protect initial margin from the default or insolvency of a counterparty, FCs and NFC+s subject to the EU margin regime must get legal certainty (either by way of an internal and independent opinion or via an external independent third party) as to whether the segregation requirements have been met.[184] In addition, the RTS require counterparties to provide documentation to their competent authority upon request supporting that the segregation arrangements in all relevant jurisdictions meet these requirements. The RTS also require counterparties subject to the EU margin regime to have procedures that ensure ongoing compliance with these requirements, particularly to show that initial margin is freely transferable to the posting counterparty in a timely manner in case of default of the collecting counterparty.[185]

Accordingly, despite the differences in required custodial arrangements, the Commission has determined that the EU's margin requirements applicable to FCs and NFC+s pertaining to custodial arrangements, segregation, and rehypothecation are comparable in outcome to the corresponding requirements under the Final Margin Rule. Specifically, the Commission finds that under both the EU's requirements and the Final Margin Rule, a CSE/FC/NFC+ is required to segregate the initial margin posted by its

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[184] *See* RTS, Article 19(6).

[185] *See* RTS, Article 19(1)(g).

counterparties under terms that ensure initial margin is protected from the default or insolvency of the collecting counterparty and freely transferable to the posting counterparty in a timely manner in case of any such default. Both regimes also prohibit the rehypothecation of initial margin. Accordingly, the Commission finds that the EU's requirements pertaining to custodial arrangements, segregation, and rehypothecation are comparable in outcome to those required by the Final Margin Rule.

L. Requirements for Margin Documentation

1. Commission Requirement for Margin Documentation

With respect to requirements for documentation of margin arrangements, the Final Margin Rule generally provides that:

- CSEs must execute documentation with each counterparty that provides 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 the Final Margin Rule.[186]

- The margin documentation must 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; describe the methods, procedures, rules, inputs, and data sources to be used to calculate initial margin for uncleared swaps entered into between the CSE and the counterparty; and 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.[187]

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[186] *See* § 23.158(a).

[187] *See* § 23.158(b).

2. EU Requirement for Margin Documentation

With respect to requirements for documentation of margin arrangements, the EU's margin rules generally provide that the terms of all necessary agreements to be entered into by counterparties, at the latest, at the moment in which a non-centrally cleared OTC derivative contract is concluded. Such documentation shall include the terms of the netting agreement and the terms of the exchange of collateral agreement, and (a) any payment obligations arising between counterparties; (b) the conditions for netting payment obligations; (c) events of default or other termination events of the non-centrally cleared OTC derivative contracts; (d) all calculation methods used in relation to payment obligations; (e) the conditions for netting payment obligations upon termination, (f) the transfer of rights and obligations upon termination; (g) the governing law of the transactions of the non-centrally cleared OTC derivative contracts.[188]

3. Commission Determination

Based on the foregoing and the representations of the applicant, the Commission has determined that the EU's margin requirements pertaining to margin documentation are substantially the same as the margin documentation requirements under the Final Margin Rule. Specifically, the Commission finds that under both the EU's requirements and the Final Margin Rule, a CSE/FC/NFC+ is required to enter into documentation with each OTC derivative/swap counterparty that sets forth the method for calculating and transferring initial and variation margin. Accordingly, the Commission finds that the EU's requirements pertaining to margin documentation are comparable in outcome to those required by the Final Margin Rule.

[188] *See* RTS, Article 2(g).

M. Cross-Border Application of the Margin Regime

1. Cross-Border Application of the Final Margin Rule

The general cross-border application of the Final Margin Rule, as set forth in the Cross-Border Margin Rule, is discussed in detail in Section II above. However, §§ 23.160(d) and (e) of the Cross-Border Margin Rule also provide certain alternative requirements for uncleared swaps subject to the laws of a jurisdiction that does not reliably recognize close-out netting under a master netting agreement governing a swap trading relationship, or that has inherent limitations on the ability of a CSE to post initial margin in compliance with the custodial arrangement requirements[189] of the Final Margin Rule.[190]

Section 23.160(d) generally provides that where a jurisdiction does not reliably recognize close-out netting, the CSE must treat the uncleared swaps covered by a master netting agreement on a gross basis with respect to collecting initial and variation margin, but may treat such swaps on a net basis with respect to posting initial and variation margin.[191]

Section 23.160(e) generally provides that where certain CSEs are required to transact with certain counterparties in uncleared swaps through an establishment in a jurisdiction where, due to inherent limitations in legal or operational infrastructure, it is impracticable to require posted initial margin to be held by an independent custodian pursuant to § 23.157, the CSE is required to collect initial margin in cash (as described in

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[189] *See* § 23.157 and Section IV(K) above.

[190] *See* § 23.160(d) and (e). Paragraph (d) of the rule addresses requirements for non-netting jurisdictions, and paragraph (e) addresses jurisdictions where compliance with custodial arrangement requirements is unavailable.

[191] *See id.*

§ 23.156(a)(1)(i)) and post and collect variation margin in cash, but is not required to post initial margin. In addition, the CSE is not required to hold the initial margin collected with an unaffiliated custodian.[192] Finally, the CSE may only enter into such affected transactions up to 5% of its total uncleared swap notional outstanding in each broad category of swaps described in § 23.154(b)(2)(v).

2. Cross-Border Application of EU's Margin Regime

With respect to cross-border transactions, the EU's margin requirements generally provide that the EC may, in order to avoid duplicative and conflicting requirements in respect of derivatives transactions, adopt implementing acts declaring that the legal, supervisory, and enforcement arrangements of a non-EU country are equivalent to the margin requirements for non-centrally cleared OTC derivatives in Article 11 or EMIR.[193] An implementing act determining equivalence shall imply that counterparties entering into a transaction within the scope of EMIR will be deemed to have fulfilled their requirements where at least one of the counterparties is established in the third country in respect of which the implementing act has been adopted, and with respect to the requirements to which the implementing act applies.[194]

With respect to non-centrally cleared OTC derivatives subject to the laws of a jurisdiction where legal enforceability of netting agreements or collateral protection cannot be ensured, the EU's margin regime provides that:

- Where counterparties enter into a netting or an exchange of collateral agreement, they shall perform an independent legal review of the enforceability of those

[192] *See* §§ 23.160(e) and 23.157(b).

[193] *See* EMIR, Article 13(2).

[194] *See* EMIR, Article 13(3).

agreements. The review may be conducted by an internal independent unit or by an independent third party.[195]

- Counterparties shall perform an independent legal review in order to verify that the segregation arrangement meets the requirements of the RTS. The review may be conducted by an internal independent unit or by an independent third party.[196]

- Counterparties established in the EU may provide in their risk management procedures that variation and initial margins are not required to be posted for non-centrally cleared OTC derivative contracts concluded with counterparties established in a third-country for which any of the following apply: (a) the legal review referred to in Article 2(3) of the RTS confirms that the netting agreement and, where used, the exchange of collateral agreement cannot be legally enforced with certainty at all times; (b) the legal review referred to in Article 19(6) of the RTS confirms that the segregation requirements of the RTS cannot be met. For the purposes of subparagraph (a), counterparties established in the EU shall collect margin on a gross basis.[197]

- Counterparties established in the EU may provide in their risk management procedures that variation and initial margins are not required to be posted or collected for contracts concluded with counterparties established in a third-country where all of the following conditions apply: (a) the legal review referred to in Article 2(3) of the RTS confirms that the netting agreement and, where used, the exchange of collateral agreement cannot be legally enforced with certainty at all times and, where applicable,

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[195] *See* RTS, Article 2(3).

[196] *See* RTS, Article 19(6).

[197] *See* RTS, Article 31(1).

the legal review referred to in Article 19(6) of the RTS confirms that the segregation requirements of the RTS cannot be met; (b) the legal reviews confirm that collecting collateral in accordance with this RTS is not possible, even on a gross basis; and (c) the OTC derivatives in a counterparty's portfolio from counterparties in non-netting jurisdictions is below 2.5%.[198]

3. Commission Determination

Based on the foregoing and the representations of the applicant, the Commission finds that the EU's margin regime with respect to its cross-border application is comparable in outcome to that of the Final Margin Rule as set forth in the Cross-Border Margin Rule.

First, the Commission recognizes that the EU's margin regime permits substituted compliance to substantially the same extent as the Cross-Border Margin Rule. For example, where a CSE finds itself subject to both the Final Margin Rule and the EU's margin regime, it may be possible under an EC equivalence determination that such CSE's compliance with the Final Margin Rule will have fulfilled the corresponding obligation under the EU's margin regime.

Second, with respect to transactions subject to the laws of a non-netting jurisdiction or a jurisdiction where collateral protection cannot be ensured, the EU's margin regime requires that margin be collected on a gross basis and, where that is not possible, that the FC/NFC+ limit their dealings in such jurisdiction to 2.5% of the OTC derivatives in the FC/NFC+'s portfolio. While this framework for non-centrally cleared OTC derivatives transacted with counterparties in these types of jurisdictions is not

[198] *See* RTS, Article 31(2) and (3).

identical to the Final Margin Rule on this subject, the Commission recognizes that the conditions requiring that margin be collected on a gross basis or, where that is not possible, such transactions be subject to a conservative limit, will serve to mitigate the potential risks associated with these types of transactions. The RTS also provides that "these treatments would be considered sufficiently prudent, because there are also other risk-mitigation techniques as an alternative to margins."[199] Moreover, before a counterparty may even consider collecting margin on a gross basis or be permitted to transact with counterparties in a non-netting jurisdiction up to any level, the EU margin rules obligate counterparties to conduct a legal review on the enforceability of netting agreements in the third-country jurisdiction and to obtain a negative independent legal review.[200]

The Commission also notes that a CSE, including a CSE that would be operating under a substituted compliance determination, is required to have a risk management program pursuant § 23.600, and thus the Commission has the authority to inquire as to the adequacy of the risk management covering uncleared swaps in non-netting jurisdictions.

Having considered the similarities and differences described above, the Commission finds that: (1) the availability of reciprocity of substituted compliance available from the EU makes the EU margin regime comparable in outcome in this respect to that of the Final Margin Rule and the Cross-Border Margin Rule; and (2) the conditions that would allow an FC/NFC+ to engage in up to 2.5% of its OTC derivatives

[199] *See* RTS, Recital (18).

[200] *See* RTS, Article 31(2).

portfolio in jurisdictions that do not recognize non-netting agreements or where collateral protection cannot be ensured, including that a counterparty must obtain a negative independent legal opinion about the enforceability of netting agreements before even considering trading with counterparties in non-netting jurisdictions, plus other risk-mitigation techniques that FC/NFC+s must have, make the EU margin regime comparable in outcome in this respect to that of the Final Margin Rule and the Cross-Border Margin Rule. Accordingly, the Commission finds the cross-border aspects of the EU's margin regime comparable in outcome to those of the Commission.

N. Supervision and Enforcement

The Commission has a long history of regulatory cooperation with the Member State competent authorities, including cooperation in the regulation of registrants of the Commission that are also FCs.[201] These competent authorities, as noted above, are responsible for supervising FCs as part of their ongoing prudential regulation and supervision of such FCs, will enforce the RTS, which are directly applicable in the Member States, and will take all measures necessary to ensure that those rules are implemented. Thus, the Commission finds that the EC, through the competent authorities, has the necessary powers to supervise, investigate, and discipline entities for compliance with its margin requirements and recognizes the relevant competent authorities' ongoing efforts to detect and deter violations of, and ensure compliance with, the margin requirements applicable in the EU.

V. Conclusion

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[201] To facilitate this cooperation, the Commission has concluded memoranda of understanding with many of the competent authorities. *See* the Commission's website at http://www.cftc.gov/International/MemorandaofUnderstanding/index.htm.

As detailed above, the Commission has noted several differences between the Final Margin Rule and the EU margin rules. However, having considered the scope and objectives of the margin requirements for uncleared swaps under the laws of the EU,[202] whether such margin requirements achieve comparable outcomes to the Commission's corresponding margin requirements,[203] and the ability of the Member State competent authorities to supervise and enforce compliance with the margin requirements for non-centrally cleared OTC derivatives under the laws of the EU,[204] the Commission has determined that the EU margin rules are comparable in outcome to the Final Margin Rule.

As noted above, the Final Margin Rule's regulatory objective is to ensure the safety and soundness of CSEs in order to offset the greater risk to CSEs and the financial system arising from the use of swaps that are not cleared. The EU margin rules require counterparties to apply robust risk-mitigation techniques to their bilateral relationships to reduce counterparty credit risk and to mitigate the potential systemic risk that could arise. Moreover, the EU margin rules achieve comparable outcomes to the Final Margin Rule in the following specific areas: the products and entities subject to the EU's margin requirements; the treatment of inter-affiliate derivative transactions; the methodologies for calculating the amounts of initial and variation margin; the process and standards for approving models for calculating initial and variation margin models; the timing and

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[202] *See* § 23.160(c)(3)(i).

[203] *See* § 23.160(c)(3)(ii). As discussed above, the Commission's Final Margin Rule is based on the BCBS/IOSCO Framework; therefore, the Commission expects that the relevant foreign margin requirements would conform to such Framework at minimum in order to be deemed comparable in outcome to the Commission's corresponding margin requirements.

[204] *See* § 23.160(c)(3)(iii). *See also* § 23.160(c)(3)(iv) (indicating the Commission would also consider any other relevant facts and circumstances).

manner in which initial and variation margin must be collected and/or paid; any threshold levels or amounts; risk management controls for the calculation of initial and variation margin; eligible collateral for initial and variation margin; the requirements of custodial arrangements, including segregation of margin and rehypothecation; margin documentation requirements; and the cross-border application of the EU's margin regime. Finally, based on the long history of regulatory cooperation between the Commission and Member State competent authorities with supervisory and enforcement authority under the RTS, the Commission finds that the EC, through the competent authorities, has the necessary powers to supervise, investigate, and discipline entities for compliance with its margin requirements, and recognizes the relevant authorities' ongoing efforts to detect and deter violations of, and ensure compliance with, the margin requirements applicable in the EU.

Accordingly, a CSE that is subject to both the Final Margin Rule and the EU's margin rules with respect to an uncleared swap that is also a non-centrally cleared OTC derivative may rely on substituted compliance for all aspects of the Final Margin Rule and the Cross-Border Margin Rule. Any such CSE that, in accordance with this comparability determination, complies with the EU margin rules, would be deemed to be in compliance with the Final Margin Rule but would remain subject to the Commission's examination and enforcement authority.[205]

Issued in Washington, DC, on October 13, 2017, by the Commission.

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[205] *See* § 23.160(c)(4).

Christopher J. Kirkpatrick,

Secretary of the Commission.

Appendix to Comparability Determination for the European Union: Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants – Commission Voting Summary

On this matter, Chairman Giancarlo and Commissioners Quintenz and Behnam voted in the affirmative. No Commissioner voted in the negative.

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