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Part II

Commodity Futures Trading Commission

17 CFR Parts 23 and 140
Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants; Proposed Rule

COMMODITY FUTURES TRADING COMMISSION

17 CFR Parts 23 and 140

RIN 3038–AC97

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

AGENCY: Commodity Futures Trading Commission.

ACTION: Proposed rule; advance notice of proposed rulemaking.

SUMMARY: The Commodity Futures Trading Commission (''Commission'' or ''CFTC'') is proposing regulations to implement section 4s(e) of the Commodity Exchange Act (''CEA''), as added by section 731 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (''Dodd-Frank Act''). This provision requires the Commission to adopt initial and variation margin requirements for certain swap dealers (''SDs'') and major swap participants (''MSPs''). The proposed rules would establish initial and variation margin requirements for SDs and MSPs but would not require SDs and MSPs to collect margin from non-financial end users. In this release, the Commission is also issuing an Advance Notice of Proposed Rulemaking requesting public comment on the cross-border application of such margin requirements. The Commission is not proposing rules on this topic at this time. It is seeking public comment on several potential alternative approaches.

DATES: Comments must be received on or before December 2, 2014.

ADDRESSES: You may submit comments, identified by RIN 3038–AC97 and Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, by any of the following methods:

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

Please submit your comments using only one of these methods.

All comments must be submitted in English, or if not, accompanied by an English translation. Comments will be posted as received to *http://www.cftc.gov*. You should submit only information that you wish to make available publicly. If you wish the Commission to consider information that may be exempt from disclosure under the Freedom of Information Act, a petition for confidential treatment of the exempt information may be submitted according to the established procedures in § 145.9 of the Commission's regulations, 17 CFR 145.9.

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

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SUPPLEMENTARY INFORMATION:

I. Background

A. Statutory Authority

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

Section 731 of the Dodd-Frank Act added a new section 4s to the CEA setting forth various requirements for SDs and MSPs. Section 4s(e) mandates the adoption of rules establishing margin requirements for SDs and MSPs.[3] Each SD and MSP for which there is a Prudential Regulator, as defined below, must meet margin requirements established by the applicable Prudential Regulator, and each SD and MSP for which there is no Prudential Regulator must comply with the Commission's regulations governing margin.

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

The definition specifies the entities for which these agencies act as Prudential Regulators. These consist generally of federally insured deposit institutions, farm credit banks, federal home loan banks, the Federal Home Loan Mortgage Corporation, and the Federal National Mortgage Association. The FRB is the Prudential Regulator under section 4s not only for certain banks, but also for bank holding companies, certain foreign banks treated as bank holding companies, and certain subsidiaries of these bank holding companies and foreign banks. The FRB is not, however, the Prudential Regulator for nonbank subsidiaries of bank holding companies, some of which are required to be registered with the Commission as SDs or MSPs. In general, therefore, the Commission is required to establish margin requirements for all registered SDs and MSPs that are not subject to a Prudential Regulator. These include, among others, nonbank subsidiaries of bank holding companies, as well as certain foreign SDs and MSPs.

Specifically, section 4s(e)(1)(B) of the CEA provides that each registered SD

[1] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (2010).

[2] 7 U.S.C. 1 *et seq.*

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

and MSP for which there is not a Prudential Regulator shall meet such minimum capital requirements and minimum initial margin and variation margin requirements as the Commission shall by rule or regulation prescribe.

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

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

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

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

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

B. Previous Proposal

Following extensive consultation and coordination with the Prudential Regulators, the Commission published proposed rules for public comment in 2011.[4] The Prudential Regulators published substantially similar rules two weeks later.[5]

The Commission received 102 comment letters. The Prudential Regulators received a comparable number. The commenters included financial services industry associations, agricultural industry associations, energy industry associations, insurance industry associations, banks, brokerage firms, investment managers, insurance companies, pension funds, commercial end users, law firms, public interest organizations, and other members of the public. The commenters addressed numerous topics including applicability of the rules to certain products, applicability to certain market participants, margin calculation methodologies, two-way vs. one-way margin, margin thresholds, permissible collateral, use of independent custodians, rehypothecation of collateral, and harmonization with other regulators.

The Commission has taken the comments it received into consideration in developing the further proposal contained herein. This proposal differs in a number of material ways from the previous proposal[6] and the Commission has determined that it is appropriate to issue a new request for comment. The Prudential Regulators have also decided to issue a new request for comment. The public is invited to comment on any aspect of the current proposal.

C. International Standards

While the comments on the 2011 proposal were being reviewed, regulatory authorities around the world determined that global harmonization of margin standards was an important goal. The CFTC and the Prudential Regulators decided to hold their rulemakings in abeyance pending completion of the international efforts.

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

In July 2012, the working group published a proposal for public comment.[7] In addition, the group conducted a Quantitative Impact Study (''QIS'') to assess the potential liquidity and other quantitative impacts associated with margin requirements.[8]

After consideration of the comments on the proposal and the results of the QIS, the group published a near-final proposal in February 2013 and requested comment on several specific issues.[9] The group considered the additional comments in finalizing the recommendations set out in the report.

The final report was issued in September 2013.[10] This report (the ''2013 international framework'') articulates eight key principles for non-cleared derivatives margin rules, which are described below. These principles represent the minimum standards approved by BCBS and IOSCO and recommended to the regulatory authorities in member jurisdictions of these organizations.

1. Appropriate Margining Practices Should be in Place With Respect to all Non-Cleared Derivative Transactions

The 2013 international framework recommends that appropriate margining practices be in place with respect to all derivative transactions that are not cleared by central counterparties (''CCPs''). The 2013 international framework does not include a margin requirement for physically settled foreign exchange (''FX'') forwards and swaps. The framework also would not apply initial margin requirements to the fixed physically-settled FX component of cross-currency swaps.

2. Financial Firms and Systemically Important Nonfinancial Entities (Covered Entities) Must Exchange Initial and Variation Margin

The 2013 international framework recommends bilateral exchange of initial and variation margin for non-cleared derivatives between covered entities. The precise definition of ''covered entities'' is to be determined by each national regulator, but in general should include financial firms and systemically important non-financial entities. Sovereigns, central banks, certain multilateral development banks, the Bank for International

[4] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 FR 23732 (April 28, 2011).

[5] Margin and Capital Requirements for Covered Swap Entities, 76 FR 27564 (May 11, 2011).

[6] These include, among others, the definition of financial end user, the definition of material swaps exposure, the requirement for two-way margin between SDs and financial end users, and the list of eligible collateral for initial margin.

[7] BCBS/IOSCO, Consultative Document, Margin requirements for non-centrally cleared derivatives (July 2012).

[8] BCBS/IOSCO, Quantitative Impact Study, Margin requirements for non-centrally cleared derivatives (November 2012).

[9] BCBS/IOSCO, Consultative Document, Margin requirements for non-centrally cleared derivatives (February 2013).

[10] BCBS/IOSCO, Margin requirements for non-centrally cleared derivatives (September 2013) (''BCBS/IOSCO Report'').

Settlements (BIS), and non-systemic, non-financial firms are not included as covered entities.

Under the 2013 international framework, all covered entities that engage in non-cleared derivatives should exchange, on a bilateral basis, the full amount of variation margin with a zero threshold on a regular basis (*e.g.,* daily). All covered entities are also expected to exchange, on a bilateral basis, initial margin with a threshold not to exceed €50 million. The threshold applies on a consolidated group, rather than legal entity, basis. In addition, and in light of the permitted initial margin threshold, the 2013 international framework recommends that entities with a level of non-cleared derivative activity of €8 billion notional or more would be subject to initial margin requirements.

3. The Methodologies for Calculating Initial and Variation Margin Should (i) Be Consistent Across Covered Entities, and (ii) Ensure That All Counterparty Risk Exposures Are Covered With a High Degree of Confidence

The 2013 international framework states that the potential future exposure of a non-cleared derivative should reflect an estimate of an increase in the value of the instrument that is consistent with a one-tailed 99% confidence level over a 10-day horizon (or longer, if variation margin is not collected on a daily basis), based on historical data that incorporates a period of significant financial stress.

The 2013 international framework permits the amount of initial margin to be calculated by reference to internal models approved by the relevant national regulator or a standardized margin schedule, but covered entities should not ''cherry pick'' between the two calculation methods. Models may allow for conceptually sound and empirically demonstrable portfolio risk offsets where there is an enforceable netting agreement in effect. However, portfolio risk offsets may only be recognized within, and not across, certain well-defined asset classes: credit, equity, interest rates and foreign exchange, and commodities. A covered entity using the standardized margin schedule may adjust the gross initial margin amount (notional exposure multiplied by the relevant percentage in the table) by a ''net-to-gross ratio,'' which is also used in the bank counterparty credit risk capital rules to reflect a degree of netting of derivative positions that are subject to an enforceable netting agreement.

4. To Ensure That Assets Collected as Collateral Can Be Liquidated in a Reasonable Amount of Time To Generate Proceeds That Could Sufficiently Protect Covered Entities From Losses in the Event of a Counterparty Default, These Assets Should Be Highly Liquid and Should, After Accounting for an Appropriate Haircut, be Able To Hold Their Value in a Time of Financial Stress

The 2013 international framework recommends that national supervisors develop a definitive list of eligible collateral assets. The 2013 international framework includes examples of permissible collateral types, provides a schedule of standardized haircuts, and indicates that model-based haircuts may be appropriate. In the event that a dispute arises over the value of eligible collateral, the 2013 international framework provides that both parties should make all necessary and appropriate efforts, including timely initiation of dispute resolution protocols, to resolve the dispute and exchange any required margin in a timely fashion.

5. Initial Margin Should be Exchanged on a Gross Basis and 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 Is Subject to Arrangements That Fully Protect the Posting Party

The 2013 international framework provides that collateral collected as initial margin from a ''customer'' (defined as a ''buy-side financial firm'') should be segregated from the initial margin collector's proprietary assets. The initial margin collector also should give the customer the option to individually segregate its initial margin from other customers' margin. In very specific circumstances, the initial margin collector may use margin provided by the customer to hedge the risks associated with the customer's positions with a third party. To the extent that the customer consents to rehypothecation, it should be permitted only where applicable insolvency law gives the customer protection from risk of loss of initial margin in instances where either or both of the initial margin collector and the third party become insolvent. Where a customer has consented to rehypothecation and adequate legal safeguards are in place, the margin collector and the third party to which customer collateral is rehypothecated should comply with additional restrictions detailed in the 2013 international framework, including a prohibition on any further rehypothecation of the customer's collateral by the third party.

6. Requirements for Transactions Between Affiliates Are Left to the National Supervisors

The 2013 international framework recommends that national supervisors establish margin requirements for transactions between affiliates as appropriate in a manner consistent with each jurisdiction's legal and regulatory framework.

7. Requirements for Margining Non-Cleared Derivatives Should Be Consistent and Non-Duplicative Across Jurisdictions

Under the 2013 international framework, home-country supervisors may allow a covered entity to comply with a host-country's margin regime if the host-country margin regime is consistent with the 2013 international framework. A branch may be subject to the margin requirements of either the headquarters' jurisdiction or the host country.

8. Margin Requirements Should Be Phased in Over an Appropriate Period of Time

The 2013 international framework phases in margin requirements between December 2015 and December 2019. Covered entities should begin exchanging variation margin by December 1, 2015. The date on which a covered entity should begin to exchange initial margin with a counterparty depends on the notional amount of non-cleared derivatives (including physically settled FX forwards and swaps) entered into both by its consolidated corporate group and by the counterparty's consolidated corporate group.

Currency denomination. The 2013 international framework recommends specific quantitative levels for several requirements such as the level of notional derivative exposure that results in an entity being subject to the margin requirements (€8 billion), permitted initial margin thresholds (€50 million), and minimum transfer amounts (€500,000). In the 2013 international framework, all such amounts are denominated in Euros. In this proposal all such amounts are denominated in U.S. dollars. The Commission is aware that, over time, amounts that are denominated in different currencies in different jurisdictions may fluctuate relative to one another due to changes in exchange rates.

The Commission seeks comment on whether and how fluctuations resulting from exchange rate movements should be addressed. In particular, should these amounts be expressed in terms of a single currency in all jurisdictions to prevent such fluctuations? Should the amounts be adjusted over time if and when exchange rate movements necessitate realignment? Are there other approaches to deal with fluctuations resulting from significant exchange rate movements? Are there other issues that should be considered in connection to the effects of fluctuating exchange rates?

II. Proposed Margin Regulations

A. Introduction

During the financial crisis of 2008–2009, DCOs met all their obligations without any financial support from the government. By contrast, significant sums were expended by governmental entities as the result of losses incurred in connection with uncleared swaps. For example, a unit of American International Group (''AIG'') entered into many credit default swaps and did not post initial margin or regularly pay variation margin on these positions.[11] AIG was unable to meet its obligations and the Federal Reserve and the Department of the Treasury expended large sums of money to meet these obligations.[12]

A key reason for this difference in the performance of cleared and uncleared swaps is that DCOs use variation margin and initial margin as the centerpiece of their risk management programs while these tools often were not universally used in connection with uncleared swaps. Consequently, in designing the proposed margin rules for uncleared swaps, the Commission has built upon the sound practices for risk management employed by central counterparties for decades.

Variation margin serves as a mechanism for periodically recognizing changes in the value of open positions and reducing unrealized losses to zero. Open positions are marked to their current market value each day and funds are transferred between the parties to reflect any change in value since the previous time the positions were marked. This process prevents losses from accumulating over time and thereby reduces both the chance of default and the size of any default should one occur.

Initial margin serves as a performance bond against potential future losses. If a party fails to meet its obligation to pay variation margin, resulting in a default, the other party may use initial margin to cover some or all of any loss. Because the payment of variation margin prevents losses from compounding over an extended period of time, initial margin only needs to cover any additional losses that might accrue between the previous time that variation margin was paid and the time that the position is liquidated.

Well-designed margin systems protect both parties to a trade as well as the overall financial system. They serve both as a check on risk-taking that might exceed a party's financial capacity and as a resource that can limit losses when there is a failure by a party to meet its obligations.

The statutory provisions cited above reflect Congressional recognition that (i) margin is an essential risk-management tool and (ii) uncleared swaps pose greater risks than cleared swaps. As discussed further below, many commenters expressed concern that the imposition of margin requirements on uncleared swaps will be very costly for SDs and MSPs.[13] However, margin has been, and will continue to be, required for all cleared products. Given the Congressional reference to the ''greater risk'' of uncleared swaps and the requirement that margin for such swaps ''be appropriate for the risk,'' the Commission believes that establishing margin requirements for uncleared swaps that are at least as stringent as those for cleared swaps is necessary to fulfill the statutory mandate. Within these statutory bounds the Commission has endeavored to limit costs appropriately, as detailed further below.

The discussion below addresses: (i) The products covered by the proposed rules; (ii) the market participants covered by the proposed rules; (iii); the nature and timing of the margin obligations; (iv) the methods of calculating initial margin; (v) the methods of calculating variation margin; (vi) permissible forms of margin; (vii) custodial arrangements; (viii) documentation requirements; (ix) the implementation schedule; and (x) advance notice of proposed rulemaking on the cross-border application of the rules.

In developing the proposed rules, the Commission staff worked closely with the staff of the Prudential Regulators.[14] In most respects, the proposed rules would establish a similar framework for margin requirements as the Prudential Regulators' proposal. Key differences are noted in the discussion below.

The proposed rules are consistent with the 2013 international framework. In some instances, as contemplated in the framework, the proposed rules provide more detail than the framework. In a few other instances, the proposed rules are stricter than the framework. Any such variations from the framework are noted in the discussion below.

B. Products

As noted above, section 4s(e)(2)(B)(ii) of the CEA directs the Commission to establish both initial and variation margin requirements for SDs and MSPs ''on all swaps that are not cleared.'' The scope provision of the proposed rules[15] states that the proposal would cover swaps that are uncleared swaps[16] and that are executed after the applicable compliance date.[17]

The term ''cleared swap'' is defined in section 1a(7) of the CEA to include any swap that is cleared by a DCO registered with the Commission. The Commission notes, however, that SDs and MSPs also clear swaps through foreign clearing organizations that are not registered with the Commission. The Commission believes that a clearing organization that is not a registered DCO must meet certain basic standards in order to avoid creating a mechanism for evasion of the uncleared margin requirements. Accordingly, the Commission is proposing to include in the definition of cleared swaps certain swaps that have been accepted for clearing by an entity that has received a no-action letter from the Commission staff or exemptive relief from the Commission permitting it to clear such swaps for U.S. persons without being registered as a DCO.[18]

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[11] *See* The Financial Crisis Inquiry Commission, The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States (Official Government Edition) at 265–268 (2011), available at *http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf*.

[12] *Id.* at 344–352, 350. *See also* United States Department of the Treasury, Office of Financial Stability, Troubled Asset Relief Program, Four Year Retrospective: An Update on the Wind Down of TARP, *pp.* 3, 18–19. Treasury and the Federal Reserve committed $182 billion to stabilize AIG. Ultimately all of this was recovered plus a return of $22.7 billion.

[13] For purposes of this proposal, the term ''SD'' means any swap dealer registered with the Commission. Similarly, the term ''MSP'' means any major swap participant registered with the Commission.

[14] As required by section 4s of the CEA, the Commission staff also has consulted with the SEC staff.

[15] Proposed Regulation § 23.150.

[16] The term uncleared swap is defined in proposed Regulation § 23.151.

[17] A schedule of compliance dates is set forth in proposed Regulation § 23.160.

[18] *See* CFTC Ltr. No. 14–107 (August 18, 2014) (granting no-action relief to Clearing Corporation of India Ltd.); CFTC Ltr. No. 14–87 (June 26, 2014) (granting no-action relief to Korea Exchange, Inc.); CFTC Ltr. No. 14–68 (May 7, 2014) (granting no-action relief to OTC Clearing Hong Kong Limited

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The Commission requests comment on whether it is appropriate to exclude swaps that are cleared by an entity that is not a registered DCO. If so, the Commission further requests comment on whether the proposed rule captures the proper clearing organizations. For example, should the Commission require that the clearing organizations be qualifying central counterparties (''QCCPs'') [19] or be subject to regulation and supervision that is consistent with the CPSS–IOSCO Principles for Financial Market Infrastructures (''PFMIs'')?

Because the pricing of swaps reflects the credit arrangements under which they were executed, it could be unfair to the parties and disruptive to the markets to require that the rules apply to positions executed before the applicable compliance dates. The rules, however, would permit SDs and MSPs voluntarily to include swaps executed before the applicable compliance date in portfolios margined pursuant to the proposed rules.[20] Many market participants might do so to take advantage of netting effects across transactions.

As a result of the determination by the Secretary of the Treasury to exempt foreign exchange swaps and foreign exchange forwards from the definition of swap,[21] the following transactions would not be subject to the requirements: (i) Foreign exchange swaps; (ii) foreign exchange forwards; and (iii) the fixed, physically settled foreign exchange transactions associated with the exchange of principal in cross-currency swaps.

In a cross-currency swap, the parties exchange principal and interest rate payments in one currency for principal and interest rate payments in another currency. The exchange of principal occurs upon the inception of the swap, with a reversal of the exchange of principal at a later date that is agreed upon at the inception of the swap. The foreign exchange transactions associated with the fixed exchange of principal in a cross-currency swap are closely related to the exchange of principal that occurs in the context of a foreign exchange forward or swap. Accordingly, the Commission is proposing to treat that portion of a cross-currency swap that is a fixed exchange of principal in a manner that is consistent with the treatment of foreign exchange forwards and swaps. This treatment of cross-currency swaps is limited to cross-currency swaps and does not extend to any other swaps such as non-deliverable currency forwards.

The Commission requests comment on the proposed treatment of products. In particular, commenters are invited to discuss the costs and benefits of the proposed approach. Commenters are urged to quantify the costs and benefits, if practicable. Commenters also may suggest alternatives to the proposed approach where the commenters believe that the alternatives would be appropriate under the CEA.

C. Market Participants

1. *SDs and MSPs*

As noted above, section 4s(e)(2)(B) of the CEA directs the Commission to impose margin requirements on SDs and MSPs for which there is no Prudential Regulator (''covered swap entities'' or ''CSEs'').[22] This provision further states that the requirement shall apply to ''all swaps that are not cleared.'' Section 4s(e)(3)(A)(2) states that the requirements must be ''appropriate to the risks associated with'' the swaps.

Because different types of counterparties can pose different levels of risk, the Commission's proposed requirements would differ depending on the category of counterparty. The proposed rules would establish three categories of counterparty: (i) SDs and MSPs, (ii) financial end users,[23] and (iii) non-financial end users.[24] As discussed below, the nature of an SD/MSP's obligations under the rules would differ depending on whether the counterparty was a covered counterparty or a non-financial end user.

2. *Financial End Users*

a. *Definition*

Financial end users would include any entity that (i) is specified in the definition, and (ii) is not an SD or MSP. The definition lists numerous entities whose business is financial in nature. The proposed rule also would permit the Commission to designate additional entities as financial end users if it identified additional entities whose activities and risk profile would warrant inclusion. As contemplated by the 2013 international framework, the CFTC proposal, which is the same as the Prudential Regulator's proposal, contains greater detail in defining financial end users than the international standards.[25]

In developing the definition, the Commission and the Prudential Regulators sought to provide clarity about whether particular counterparties would be subject to the margin requirements of the proposed rule. The definition is an attempt to strike a balance between the need to capture all financial counterparties that pose significant risk to the financial system and the danger of being overly inclusive.

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

The list of financial entities is based to a significant extent on Federal statutes that impose registration or chartering requirements on entities that engage in specified financial activities. Such activities include deposit taking and lending, securities and swaps dealing, investment advisory activities, and asset management.

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

The proposal also would cover a broad variety and number of nonbank lending and retail payment firms that operate in the market. To this end, the proposal would include State-licensed or registered credit or lending entities

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and certain of its clearing members); CFTC Ltr. No. 14–27 (Mar. 20, 2014) (extending previous grant of no-action relief to Eurex Clearing AG and certain of its clearing members); CFTC Ltr. No. 14–07 (Feb. 6, 2014) (granting no-action relief to ASX Clear (Futures) Pty Limited); and CFTC Ltr. No. 13–73 (Dec. 19, 2013) (extending previous grant of no-action relief to Japan Securities Clearing Corporation and certain of its clearing members).

[19] A QCCP is a clearing organization that meets the standards to be designated as such set forth by the Basel Committee for Banking Supervision in the report ''Capital requirements for bank exposures to central counterparties'' (April 2014).

[20] *See* proposed Regulation § 23.154(b)(2) for initial margin and proposed Regulation § 23.153(c) for variation margin.

[21] Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, 77 FR 69694 (Nov. 20, 2012).

[22] This term is defined in proposed Regulation § 23.151.

[23] This term is defined in proposed Regulation § 23.151.

[24] This term is defined in proposed Regulation § 23.151 to include entities that are not SDs, MSPs, or financial entities.

[25] ''The precise definition of financial firms, non-financial firms, and systemically important non-financial firms will be determined by appropriate national regulation.'' *See* BCBS/IOSCO Report at 9.

and money services businesses, under proposed regulatory language incorporating an inclusive list of the types of firms subject to State law.[26] However, the Commission recognizes that the licensing of nonbank lenders in some states extends to commercial firms that provide credit to the firm's customers in the ordinary course of business. Accordingly, the Commission is proposing to exclude an entity registered or licensed solely because it finances the entity's direct sales of goods or services to customers. The Commission requests comment on whether this aspect of the proposed rule adequately maintains a distinction between financial end users and commercial end users.

In addition, real estate investment companies would be financial end users, as they are entities that would be investment companies under section 3 of the Investment Company Act but for section 3(c)(5)(C). Furthermore, other securitization vehicles would be financial end users in cases where those vehicles are entities that are deemed not to be investment companies under section 3 of the Investment Company Act pursuant to Rule 3a–7. The Commission also notes that the category of investment companies registered with the SEC under the Investment Company Act would include registered investment companies as well as business development companies.

Under the proposed rule, those cooperatives that are financial institutions, such as credit unions, Farm Credit System banks and associations, and the National Rural Utilities Cooperative Finance Corporation would be financial end users because their sole business is lending and providing other financial services to their members, including engaging in swaps in connection with such loans.[27] Cooperatives that are financial end users may qualify for an exemption from clearing,[28] and therefore, they may enter into non-cleared swaps with covered swap entities that are subject to the proposed rule.

The Commission remains concerned, however, that one or more types of financial entities might escape classification under the specific Federal or State regulatory regimes included in the proposed definition of a financial end user. Accordingly, the definition includes two additional prongs. First, the definition would cover an entity that is, or holds itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in loans, securities, swaps, funds or other assets for resale or other disposition or otherwise trading in loans, securities, swaps, funds or other assets. The Commission requests comment on the extent to which there are (or may be in the future) pooled investment vehicles that are not captured by the other prongs of the definition (such as the provisions covering private funds under the Investment Advisers Act or commodity pools under the CEA). The Commission also requests comment on whether this aspect of the definition of financial end user provides sufficiently clear guidance to covered swap entities and market participants as to its intended scope, and whether it adequately maintains a distinction between financial end users and commercial end users.

Second, the proposal would allow the Commission to require a swap dealer and major swap participant (''covered swap entity'') to treat an entity as a financial end user for margin purposes, even if the person is not specifically listed within the definition of ''financial end user'' or if the entity is excluded from the definition of financial end user as described below. This provision was included out of an abundance of caution to act as a safety mechanism in the event that an entity didn't fall squarely within one of the listed categories but was effectively acting as a financial end user.

To address the classification of foreign entities as financial end users, the proposal would require the covered swap entity to determine whether a foreign counterparty would fall within another prong of the financial end user definition if the foreign entity was organized under the laws of the United States or any State. The Commission recognizes that this approach would impose upon covered swap entities the difficulties associated with analyzing a foreign counterparty's business activities in light of a broad array of U.S. regulatory requirements. The alternative, however, would require covered swap entities to gather a foreign counterparty's financial reporting data and determine the relative amount of enumerated financial activities in which the counterparty is engaged over a rolling period.[29] The Commission requests comment on whether some other method or approach would adequately assure that the rule's objectives with respect to dealer safety and soundness and reductions of systemic risk can be achieved, in a fashion that can be more readily operationalized by covered swap entities. For example, would it be appropriate to have foreign counterparties certify to CSEs whether they are financial end users or not? This could be operationally simpler for the CSEs and would avoid the circumstance where one CSE, in good faith, deemed a foreign counterparty to be a financial end user and another CSE, in good faith, did not.

The definition of financial entities[30] would exclude the government of any country, central banks, multilateral development banks, the Bank for International Settlements, captive finance companies,[31] and agent affiliates.[32] The exclusion for sovereign entities, multilateral development banks and the Bank for International Settlements is consistent with the 2013 international framework and the proposal of the Prudential Regulators.

[26] The Commission expects that financial cooperatives that provide financial services to their members, such as lending to their members and entering into swaps in connection with those loans, would be treated as financial end users, pursuant to this aspect of the proposed rule's coverage of credit or lending entities.

[27] Under the proposed rule, the financing subsidiaries or affiliates of producer or consumer cooperatives would be non-financial end users.

[28] Section 2(h)(7)(c)(ii) of the CEA and section 3C(g)(4) of the Securities Exchange Act of 1934 authorize the CFTC and the SEC, respectively, to exempt small depository institutions, small Farm Credit System institutions, and small credit unions with total assets of $10 billion or less from the mandatory clearing requirements for swaps and security-based swaps. Additionally, the CFTC, pursuant to its authority under section 2(h)(1)(A) of the CEA, enacted 17 CFR 50.51, which allows cooperative financial entities, including those with total assets in excess of $10 billion, to elect an exemption from mandatory clearing of swaps that: (1) They enter into in connection with originating loans for their members; or (2) hedge or mitigate commercial risk related to loans or swaps with their members.

[29] *See e.g.,* Definitions of ''Predominantly Engaged In Financial Activities'' and ''Significant Nonbank Financial Company and Bank Holding Company'', 68 FR 20756 (April 5, 2013).

[30] Proposed Regulation § 23.151.

[31] A captive finance company is an entity that is excluded from the definition of financial entity under section 2(h)(7)(c)(iii) of the CEA for purposes of the requirement to submit certain swaps for clearing. That section describes it as ''an entity whose primary business is providing financing, and uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 90 percent or more of which arise from financing that facilitates the purchase or lease of products, 90 percent or more of which are manufactured by the parent company or another subsidiary of the parent company.''

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

Captive finance companies and agent affiliates were excluded by the Dodd-Frank Act from the definition of financial entity subject to mandatory clearing.

The Commission notes that States would not be excluded from the definition of financial end user, as the term ''sovereign entity'' includes only central governments. The categorization of a State or particular part of a State as a financial end user depends on whether that part of the State is otherwise captured by the definition of financial end user. For example, a State entity that is a ''governmental plan'' under ERISA would meet the definition of financial end user.

For a foreign entity that was not a central government, a foreign regulator could request a determination whether the entity was a financial end user. Such a determination could extend to other similarly situated entities in that jurisdiction.

The Commission seeks comment on all aspects of the financial end user definition, including whether the definition has succeeded in capturing all entities that should be included. The Commission requests comment on whether there are additional entities that should be included as financial end users and, if so, how those entities should be defined. Further, the Commission also requests comment on whether there are additional entities that should be excluded from the definition of financial end user and why those particular entities should be excluded. The Commission also requests comment on whether another approach to defining financial end user (*e.g.,* basing the financial end user definition on the financial entity definition as in the 2011 proposal) would provide more appropriate coverage and clarity, and whether covered swap entities could operationalize such an approach as part of their regular procedures for taking on new counterparties.

The Commission requests comment on the costs and benefits of the proposed definition of financial end user. Commenters are urged to quantify the costs and benefits, if practicable. Commenters also may suggest alternatives to the proposed approach where the commenters believe that the alternatives would be appropriate under the CEA.

b. Small Banks

As noted above, banks would be financial end users under the proposal. They would be subject to initial margin requirements if they entered into uncleared swaps with CSEs and, as discussed below, had material swaps exposure. Staff of the Prudential Regulators have indicated that they expect that the proposed rule likely will have minimal impact on small banks.

Staff of the Prudential Regulators believe that the vast majority of small banks do not engage in swaps at or near that level of activity that would meet the material swaps exposure threshold. If, however, a small bank did exceed the threshold level, the Prudential Regulators believe it would be appropriate for the protection of both the CSE and the small bank for two-way initial margin to be posted. The Commission notes that, as discussed in more detail below, initial margin would only need to be posted to the extent it exceeded $65 million.

The proposed rule would require a CSE to exchange daily variation margin with a small bank, regardless of whether the institution had material swap exposure. However, the covered swap entity would only be required to collect variation margin from a small bank when the amount of both initial margin and variation margin required to be collected exceeded $650,000. The Prudential Regulators have indicated that they expect that the vast majority of small banks will have a daily margin requirement that is below this amount.

The Commission requests comment on all aspects of the proposed treatment of small banks. In particular, the Commission requests comment on the interaction of this proposal with clearing exemptions that have been granted.[33]

c. Affiliates of CSEs

The proposal generally would cover swaps between CSEs and their affiliates that are financial end users. The Commission notes that other applicable laws require transactions between banks and their affiliates to be on an arm's length basis. For example, section 23B of the Federal Reserve Act provides that many transactions between a bank and its affiliates must be on terms and under circumstances, including credit standards, that are substantially the same or at least as favorable to the bank as those prevailing at the time for comparable transactions with or involving nonaffiliated companies.[34] Consistent with that treatment, the Prudential Regulators and the Commission are proposing to apply the margin requirements to swaps between CSEs and their affiliates.

The Commission requests comment on all aspects of the proposed treatment of transactions with affiliates. In particular, the Commission requests comment on the interaction of this proposal with clearing exemptions that have been granted.

d. Multilateral Development Banks

The proposed definition of the term ''multilateral development bank,'' includes a provision encompassing ''[a]ny other entity that provides financing for national or regional development in which the U.S. government is a shareholder or contributing member or which the Commission determines poses comparable credit risk.'' The Commission seeks comment regarding this definition. In particular, is the criterion of comparability of credit risk appropriate for this definition? Should the Commission look to other characteristics of the entity in determining whether it should be within the definition of ''multilateral development bank''?

e. Material Swaps Exposure

A CSE would not be required to exchange initial margin with a financial end user if the financial end user did not have ''material swaps exposure.''[35] Material swaps exposure would be computed using the average daily aggregate notional amount of uncleared swaps, security-based swaps, foreign exchange forwards, and foreign exchange swaps[36] with all counterparties for June, July, and August of the previous calendar year. Essentially, a financial end user would have material swaps exposure if it held an aggregate gross notional amount of these products of more than $3 billion.[37]

This provision recognizes that a financial end user that has relatively smaller positions does not pose the same risks as a financial end user with

[33] *See* Commission Regulations §§ 50.50(d)(small banks), 50.51 (cooperatives), 50.52 (inter-affiliate trades), and CFTC Ltr. No. 13–22 (June 4, 2013) (treasury affiliates).

[34] 12 U.S.C. 371c–1(a).

[35] Proposed Regulation § 23.152 applies to ''covered counterparties.'' Proposed Regulation § 23.151 defines that term to include financial entities with material swaps exposure.

[36] The 2013 international framework states that all uncleared derivatives, ''including physically settled FX forwards and swaps'' should be included in determining whether a covered entity should be subject to margin requirements. BCBS/IOSCO Report Paragraph 8.8. Although these products would not themselves be subject to margin requirements, they are uncleared derivatives that pose risks. It was the judgment of BCBS/IOSCO that they should be included in identifying significant market participants in the uncleared space. Consistent with international standards and with the Prudential Regulators' proposal, the Commission is proposing to include them for purposes of this calculation.

[37] Proposed Regulation § 23.151.

larger positions. By reducing the number of market participants subject to certain margin requirements, it also addresses the concerns that have been expressed about the availability of sufficient collateral to meet these requirements.

While adoption of a material swaps exposure threshold is consistent with the 2013 international framework,[38] the Commission and the Prudential Regulators, are proposing to set the materiality standard lower than the international standard. However, the lower standard was chosen in order to be consistent with the intent of the international standards, which was to require collection of margin only when the amount exceeds $65 million, as explained below.

The 2013 international framework defines smaller financial end users as those counterparties that have a gross aggregate amount of covered swaps below €8 billion, which, at current exchange rates, is approximately equal to $11 billion. The preliminary view of the Commission and the Prudential Regulators is that defining material swaps exposure as a gross notional exposure of $3 billion, rather than $11 billion, is appropriate because it reduces systemic risk without imposing undue burdens on covered swap entities, and therefore, is consistent with the objectives of the Dodd-Frank Act. This view is based on data and analyses that have been conducted since the publication of the 2013 international framework.

Specifically, the Commission and the Prudential Regulators have reviewed actual initial margin requirements for a sample of cleared swaps. These analyses indicate that there are a significant number of cases in which a financial end user would have a material swaps exposure level below $11 billion but would have a swap portfolio with an initial margin collection amount that significantly exceeds the proposed permitted initial margin threshold amount of $65 million. The intent of both the Commission and the 2013 international framework is that the initial margin threshold provide smaller counterparties with relief from the operational burden of measuring and tracking initial margin collection amounts that are expected to be below $65 million. Setting the material swaps exposure threshold at $11 billion appears to be inconsistent with this intent, based on the recent analyses.

The table below summarizes actual initial margin requirements for 4,686 counterparties engaged in cleared interest rate swaps. Each counterparty represents a particular portfolio of cleared interest rate swaps. Each counterparty had a swap portfolio with a total gross notional amount less than $11 billion and each is a customer of a CCP's clearing member. Column (1) displays the initial margin amount as a percentage of the gross notional amount. Column (2) reports the initial margin, in millions of dollars that would be required on a portfolio with a gross notional amount of $11 billion.

INITIAL MARGIN AMOUNTS ON 4,686 CLEARED INTEREST RATE SWAP PORTFOLIOS

	Column (1) initial margin amount as percentage of gross notional amount (%)	Column (2) initial margin amount on an $11 billion gross notional portfolio ($MM)
Average	2.1	231
25th Percentile	0.6	66
50th Percentile	1.4	154
75th Percentile	2.7	297

As shown in the table above, the average initial margin rate across all 4,686 counterparties, reported in Column (1), is 2.1 percent, which would equate to an initial margin collection amount, reported in Column (2), of $231 million on an interest rate swap portfolio with a gross notional amount of $11 billion. This average initial margin collection amount significantly exceeds the proposed permitted threshold amount of $65 million. Seventy-five percent of the 4,686 cleared interest rate swap portfolios exhibit an initial margin rate in excess of 0.6 percent, which equates to an initial margin amount on a cleared interest rate swap portfolio of $66 million (approximately equal to the proposed permitted threshold amount).

The data above represent actual margin requirements on a sample of interest rate swap portfolios that are cleared by a single CCP. Some CCPs also provide information on the initial margin requirements on specific and representative swaps that they clear. The Chicago Mercantile Exchange (''CME''), for example, provides information on the initial margin requirements for cleared interest rate swaps and credit default swaps that it clears. This information does not represent actual margin requirements on actual swap portfolios that are cleared by the CME but does represent the initial margin that would be required on specific swaps if they were cleared at the CME. The table below presents the initial margin requirements for two swaps that are cleared by the CME.

INITIAL MARGIN AMOUNTS ON CME CLEARED INTEREST RATE AND CREDIT DEFAULT SWAPS

	Column (1) initial margin amount as percentage of gross notional amount (%)	Column (2) initial margin amount on an $11 billion gross notional portfolio ($MM)
5 year, receive fixed and pay floating rate interest rate swap	2.0	216
5 year, sold CDS protection on the CDX IG Series 20 Version 22 Index	1.9	213

[38] BCBS/IOSCO Report at 9.

According to the CME, the initial margin requirement on the interest rate swap and the credit default swap are both roughly two percent of the gross notional amount. This initial margin rate translates to an initial margin amount of roughly $216 million on a swap portfolio with a gross notional amount of $11 billion. Accordingly, this data also indicates that the initial margin collection amount on a swap portfolio with a gross notional size of $11 billion could be significantly larger than the proposed permitted initial margin threshold of $65 million.

In addition to the information provided in the tables above, the Commission's preliminary view is that additional considerations suggest that the initial margin collection amounts associated with uncleared swaps could be even greater than those reported in the tables above. The tables above represent initial margin requirements on cleared interest rate and credit default index swaps. Uncleared swaps in other asset classes, such as single name equity or single name credit default swaps, are likely to be riskier and hence would require even more initial margin. In addition, uncleared swaps often contain complex features, such as nonlinearities, that make them even riskier and would hence require more initial margin. Finally, uncleared swaps are generally expected to be less liquid than cleared swaps and must be margined, under the proposed rule, according to a ten-day close-out period rather than the five-day period required for cleared swaps. The data presented above pertains to cleared swaps that are margined according to a five-day and not a ten-day close-out period. The requirement to use a ten-day close-out period would further increase the initial margin requirements of uncleared versus cleared swaps.

In light of the data and considerations noted above, the Commission's preliminary view is that it is appropriate and consistent with the intent of the 2013 international framework to identify a material swaps exposure with a gross notional amount of $3 billion rather than $11 billion (€8 billion) as is suggested by the 2013 international framework. Identifying a material swaps exposure with a gross notional amount of $3 billion is more likely to result in an outcome in which entities with a gross notional exposure below the material swaps exposure amount would be likely to have an initial margin collection amount below the proposed permitted initial margin threshold of $65 million. The Commission does recognize, however, that even at the lower amount of $3 billion, there are likely to be some cases in which the initial margin collection amount of a portfolio that is below the material swaps exposure amount will exceed the proposed permitted initial margin threshold amount of $65 million. The Commission's preliminary view is that such instances should be relatively rare and that the operational benefits of using a simple and transparent gross notional measure to define the material swaps exposure amount are substantial.

The Commission notes that under the implementation schedule set out below, this requirement would not take effect until January 1, 2019.[39] Parties with gross notional exposures around this amount would have several years notice before the requirements took effect.

The Commission requests comment on all aspects of the material swaps exposure provision. In particular, the Commission requests comment on the proposal to establish a level that is lower than the level set forth in the 2013 international framework. Are there alternative measurement methodologies that do not rely on gross notional amounts that should be used? Does the proposed rule's use and definition of the material swaps exposure raise any competitive equity issues that should be considered? Are there any other aspects of the material swaps exposure that should be considered by the Commission?

The Commission requests comment on the costs and benefits of the proposed definition of material swaps exposure. Commenters are urged to quantify the costs and benefits, if practicable. Commenters also may suggest alternatives to the proposed approach where the commenters believe that the alternatives would be appropriate under the CEA.

3. Non-Financial End Users

Non-financial end users would include any entity that was not an SD, an MSP, or a financial end user. The proposal would not require CSEs to exchange margin with non-financial end users. The Commission believes that such entities, which generally are using swaps to hedge commercial risk, pose less risk to CSEs than financial entities. Therefore, under section 4s(e)(3)(A)(ii) of the CEA, applying a different standard to trades by CSEs with non-financial entities than to trades by CSEs with covered counterparties would be ''appropriate to the risk.''

This approach is consistent with Congressional intent. Senior Congressional leaders have stated that they do not believe that non-financial end users should be required to post margin for uncleared swaps.[40] In addition, the Dodd-Frank Act generally exempted non-financial end users from the requirement that they submit trades to clearing.[41] If the Commission required them to post margin for uncleared trades, the clearing exemption could be weakened because the costs of clearing are likely to be less than the costs of margining an uncleared position. This approach is also consistent with international standards.[42]

The Commission's proposal is generally consistent with the proposal of the Prudential Regulators but differs in some particulars. The Prudential Regulators' proposal contains the following provision:

> A covered swap entity is not required to collect initial margin with respect to any non-cleared swap or non-cleared security-based swap with a counterparty that is neither a financial end user with material swaps exposure nor a swap entity but shall collect initial margin at such times and in such forms (if any) that the covered swap entity determines appropriately address the credit risk posed by the counterparty and the risks of such non-cleared swaps and non-cleared security-based swaps.

The Commission's proposal does not contain this provision.

The Commission's proposal contains other provisions designed to address the mandate under section 4s(e)(3)(A)(i) that Commission rules ''help ensure the safety and soundness'' of SDs and MSPs. First, as discussed further below, the rules would require CSEs to enter into certain documentation with all counterparties, including non-financial entities, to provide clarity about the parties' respective rights and obligations.[43] CSEs and non-financial

[39] Proposed Regulation § 23.160.

[40] Letter from Chairman Debbie Stabenow, Committee on Agriculture, Nutrition and Forestry, U.S. Senate, Chairman Frank D. Lucas, Committee on Agriculture, United States House of Representatives, Chairman Tim Johnson, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, and Chairman Spencer Bachus, Committee on Financial Services, United States House of Representatives to Secretary Timothy Geithner, Department of Treasury, Chairman Gary Gensler, U.S. Commodity Futures Trading Commission, Chairman Ben Bernanke, Federal Reserve Board, and Chairman Mary Shapiro, U.S. Securities and Exchange Commission (April 6, 2011); Letter from Chairman Christopher Dodd, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, and Chairman Blanche Lincoln, Committee on Agriculture, Nutrition, and Forestry, U.S. Senate, to Chairman Barney Frank, Financial Services Committee, United States House of Representatives, and Chairman Collin Peterson, Committee on Agriculture, United States House of Representatives (June 30, 2010); *see also* 156 Cong. Rec. S5904 (daily ed. July 15, 2010) (statement of Sen. Lincoln).

[41] *See* section 2(h)(7) of the CEA.

[42] BCBS/IOSCO Report at pp. 7–8.

[43] Proposed Regulation § 23.158.

entities would be free to set initial margin and variation margin requirements, if any, in their discretion and any thresholds agreed upon by the parties would be permitted.

Second, the proposal would require each CSE to calculate hypothetical initial and variation margin amounts each day for positions held by non-financial entities that have material swaps exposure to the covered counterparty.[44] That is, the CSE must calculate what the margin amounts would be if the counterparty were another SD or MSP and compare them to any actual margin requirements for the positions.[45] These calculations would serve as risk management tools to assist the CSE in measuring its exposure and to assist the Commission in conducting oversight of the CSE.

D. Nature and Timing of Margin Requirements

1. Initial Margin

Subject to thresholds discussed below, the proposal would require each CSE to collect initial margin from, and to post initial margin with, each covered counterparty on or before the business day after execution [46] for every swap with that counterparty.[47] The proposal would require the CSEs to continue to post and to collect initial margin until the swap is terminated or expires.[48]

Recognizing that SDs and MSPs pose greater risk to the markets and the financial system than other swap market participants, Congress established a comprehensive regulatory scheme for them including registration, recordkeeping, reporting, margin, capital, and business conduct requirements. Accordingly, under the mandate of section 4s(e)(3)(C) to preserve the financial integrity of markets trading swaps and to preserve the stability of the United States financial system, the Commission is proposing to require SDs and MSPs to collect initial margin from, and to post initial margin with, one another.

Similarly, as discussed above, the Commission believes that financial end users with material swaps exposure potentially pose greater risk to CSEs and to the financial system than non-financial end users or financial end users with smaller aggregate exposures. Accordingly, under the mandate of section 4s(e)(3)(A) to help ensure the safety and soundness of SDs and MSPs, the Commission is proposing to require SDs and MSPs to collect initial margin from, and to post initial margin with, financial end users.

Notably, the proposal would require both collecting and posting of initial margin by CSEs (''two-way margin''). Two-way margin helps to ensure the safety and soundness of CSEs. Daily collection of initial margin increases the safety and soundness of the CSE by providing collateral to cover potential future exposure from each counterparty. That is, if a counterparty fails to meet an obligation, the CSE can liquidate the initial margin that it holds to cover some or all of the loss. But daily posting of initial margin also helps to ensure the safety and soundness of a CSE by making it more difficult for the CSE to build up exposures that it cannot fulfill. That is, the requirement that a CSE post initial margin acts as a discipline on its risk taking. The requirement also would make it more difficult for a rogue trader to hide his positions.

In the wake of clearing mandates, uncleared swaps are likely to be more customized and consequently trade in a less liquid market than cleared swaps. As a result, uncleared swaps potentially might take a longer time and require a greater price premium to be liquidated than cleared swaps, particularly in distressed market conditions. Initial margin is designed to address these risks.

The proposal contains a provision stating that a CSE would not be deemed to have violated its obligation to collect initial margin if it took certain steps.[49] Specifically, if a counterparty failed to pay the required initial margin to the CSE, the CSE would be required to make the necessary efforts to attempt to collect the initial margin, including the timely initiation and continued pursuit of formal dispute resolution mechanisms,[50] or otherwise demonstrate upon request to the satisfaction of the Commission that it has made appropriate efforts to collect the required initial margin or commenced termination of the swap.

The Commission requests comment on all aspects of the proposal relating to the nature and timing of initial margin. In particular, the Commission requests comment on two-way initial margin.

The Commission requests comment on the costs and benefits of the proposed approach. Commenters are urged to quantify the costs and benefits, if practicable. Commenters also may suggest alternatives to the proposed approach where the commenters believe that the alternatives would be appropriate under the CEA.

2. Variation Margin

Subject to a minimum transfer amount discussed below, the proposal would require each CSE to collect variation margin from, and to pay variation margin to, each counterparty that is a swap entity or a financial end user, on or before the end of the business day after execution for each swap with that counterparty.[51] The proposed rule would require the CSEs to continue to pay or collect variation margin each business day until the swap is terminated or expires.[52]

Two-way variation margin would protect the safety and soundness of CSEs for the same reasons discussed above in connection with initial margin. Two-way variation margin has been a keystone of the ability of DCOs to manage risk. Each day, starting on the day after execution, current exposure is removed from the market through the payment and collection of variation margin.

If two-way variation margin were not required for uncleared swaps between CSEs and counterparties that are swap entities or financial end users, current exposures might accumulate beyond the financial capacity of a counterparty. In contrast to initial margin, which is designed to cover potential future exposures, variation margin addresses actual current exposures, that is, losses that have already occurred. Unchecked accumulation of such exposures was one of the characteristics of the financial crisis which, in turn, led to the enactment of the Dodd-Frank Act.[53] As with initial margin, the Commission believes that requiring covered swap entities both to collect and pay margin with these counterparties effectively reduces systemic risk by protecting both the covered swap entity and its

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

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

[46] Commission Regulation § 23.200(e) defines execution to mean, ''an agreement by the counterparties (whether orally, in writing, electronically, or otherwise) to the terms of the swap transaction that legally binds the counterparties to such terms under applicable law.'' 17 CFR 23.200(e).

[47] Proposed Regulation § 23.152(a).

[48] Proposed Regulation § 23.152(b).

[49] Proposed Regulation § 23.152(c).

[50] *See* Commission Regulation § 23.504(b)(4).

[51] Proposed Regulation § 23.153(a).

[52] Proposed Regulation § 23.153(b).

[53] *See* The Financial Crisis Inquiry Commission, The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States (Official Government Edition) at 265–268 (2011), available at *http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf.*

counterparty from the effects of a default.

In contrast to the initial margin requirement, which would only apply to financial end users with material swaps exposure, the proposed variation margin requirement would apply to all financial end users regardless of whether the entity had material swaps exposure. This is consistent with international standards.[54] It reflects the Commission's view that variation margin is an important risk mitigant that (i) reduces the build-up of risk that may ultimately pose systemic risk and (ii) imposes a lesser liquidity burden than does initial margin. Moreover, this approach is consistent with current market practice.

The proposal would permit netting of variation margin across swaps.[55] Any netting would have to be done pursuant to an eligible master netting agreement.[56] The agreement would create a single legal obligation for all individual transactions covered by the agreement upon an event of default. It would specify the rights and obligations of the parties under various circumstances.[57]

As is the case for initial margin, the proposal contains a provision stating that a CSE would not be deemed to have violated its obligation to collect variation margin if it took certain steps.[58] Specifically, if a counterparty failed to pay the required variation margin to the CSE, the CSE would be required to make the necessary efforts to attempt to collect the variation margin, including the timely initiation and continued pursuit of formal dispute resolution mechanisms, including pursuant to Commission Regulation 23.504(b)(4), if applicable, or otherwise demonstrate upon request to the satisfaction of the Commission that it has made appropriate efforts to collect the required variation margin or commenced termination of the swap.

The Commission requests comment on all aspects of the proposal relating to the nature and timing of variation margin.

The Commission requests comment on the costs and benefits of the proposed approach. Commenters are urged to quantify the costs and benefits, if practicable. Commenters also may suggest alternatives to the proposed approach where the commenters believe that the alternatives would be appropriate under the CEA.

[54] BCBS/IOSCO Report at 9.

[55] Proposed Regulation § 23.153(c).

[56] Proposed Regulation § 23.151, definition of ''eligible master netting agreement.''

[57] *Id.*

[58] Proposed Regulation § 23.153(d).

E. Calculation of Initial Margin

1. *Overview*

Under the proposed rules, a CSE could calculate initial margin using either a model-based method or a standardized table-based method.[59] The required amount of initial margin would be the amount computed pursuant to the model or the table minus a threshold amount of $65 million.[60] This amount could not be less than zero.[61] The initial margin specified under the rule would be a minimum requirement, and the parties would be free to require more initial margin.

When a CSE entered into a swap with a counterparty that was either another CSE or an SD/MSP subject to a Prudential Regulator, each party would bear the responsibility for calculating the amount that it would collect.[62] Thus, for such trades, the amount a party posted could differ from the amount it collected either because of differences in their respective methodologies or because the product has asymmetric risk. As a practical matter, the Commission understands that the industry is working to develop common standards that would minimize this for methodologies.

When, however, a CSE entered into a swap with a financial entity, the CSE would have responsibility for calculating both the amount it collected and the amount it posted.[63] This is because the statute does not directly impose margin requirements on financial entities. They only come within the scope of section 4s when they trade with SDs or MSPs.

As noted, the rules would permit CSEs and their covered counterparties to establish margin thresholds of up to $65 million. This means that the parties could agree not to post and/or to collect any margin amount falling below this threshold level. For covered entities that were part of a consolidated group, a single threshold would be applied across the consolidated group, not individually to each entity.[64] This threshold is consistent with the 50 million Euro threshold set forth in the international standards as is the consolidated group requirement.[65] The Prudential Regulators proposed the same treatment in this regard.

[59] Proposed Regulation § 23.154.

[60] Proposed Regulation § 23.151, definition of ''initial margin threshold amount.''

[61] Proposed Regulation § 23.154(a)(4).

[62] Proposed Regulation § 23.152(a).

[63] Proposed Regulation § 23.154(b).

[64] Proposed Regulation § 23.151, definition of ''initial margin threshold amount.''

[65] BCBS/IOSCO Report at 9.

Concern has been expressed by some in the industry about the potential expense of two-way margin. The $65 million threshold is designed to mitigate that expense while continuing to protect the financial integrity of CSEs and the financial system. Smaller exposures would be permitted to go uncollateralized, but a significant percentage of all large exposures would be supported by collateral.

For example, if the initial margin calculated for a particular trade were $55 million, the CSE would not be required to post or to collect initial margin because the amount would be below the $65 million threshold. If the margin amount were $75 million, the CSE would only be required to post and to collect $10 million, the amount the margin calculation exceeded the $65 million threshold.

In order to reduce transaction costs, the proposal would establish a ''minimum transfer amount'' of $650,000.[66] Initial and variation margin payments would not be required to be made if the payment were below that amount. This amount is consistent with international standards.[67] It represents an amount sufficiently small that the level of risk reduction might not be worth the transaction costs of transferring the money. It would affect only the timing of collection; it would not change the amount of margin that must be collected once the $650,000 level was exceeded.

For example, if a party posted $80 million as initial margin on Monday and the requirement increased to $80,400,000 on Tuesday, the party would not be required to post additional funds on Tuesday because the $400,000 increase would be less than the minimum transfer amount. If, however, on Wednesday, the requirement increased by another $400,000 to $80,800,000, the party would be required to post the entire $800,000 additional amount.

The Commission requests comment on the $65 million threshold and the $650,000 minimum transfer amount. The Commission requests comment on the costs and benefits of the proposed approach. Commenters are urged to quantify the costs and benefits, if practicable. Commenters also may suggest alternatives to the proposed approach where the commenters believe that the alternatives would be appropriate under the CEA.

[66] Proposed Regulation § 23.154(a)(3).

[67] BCBS/IOSCO Report at 9.

2. Models

a. Commission Approval

Consistent with international standards, the proposal would require CSEs to obtain the written approval of the Commission before using a model to calculate initial margin.[68] Further, the CSE would have to demonstrate that the model satisfied all of the requirements of this section on an ongoing basis.[69] In addition, a CSE would have to notify the Commission in writing before extending the use of a model that has been approved to an additional product type, making any change to any initial margin model that has been approved that would result in a material change in the CSE's assessment of initial margin requirements; or making any material change to assumptions used in the model.[70] The Commission could rescind its approval of a model if the Commission determined that the model no longer complied with this section.[71]

Given the central place of modeling in most margin systems and the complexity of the process, the Commission believes that these oversight provisions are necessary. The resources that would be needed, however, to initially review and to periodically assess margin models present a significant challenge to the Commission. To address this issue, the Commission would seek to coordinate with both domestic and foreign authorities in the review of models.

In many instances, CSEs whose margin models would be subject to Commission review would be affiliates of entities whose margin models would be subject to review by one of the Prudential Regulators. In such situations, the Commission would coordinate with the Prudential Regulators in order to avoid duplicative efforts and to provide expedited approval of models that a Prudential Regulator had already approved. For example, if a Prudential Regulator had approved the model of a depository institution registered as an SD, Commission review of a comparable model used by a non-bank affiliate of that SD would be greatly facilitated. Similarly, the Commission would coordinate with the SEC for CSEs that are dually registered and would coordinate with foreign regulators that had approved margin models for foreign CSEs. For CSEs that that wished to use models that were not reviewed by a Prudential Regulator, the SEC, or a foreign regulator, the Commission would coordinate, if possible, with the National Futures Association (''NFA'') as each CSE would be required to be a member of the NFA.

The Commission requests comment on all aspects of the proposed margin approval process. Specifically, the Commission requests comment on the appropriateness and feasibility of coordinating with the Prudential Regulators, the SEC, foreign regulators, and the NFA in this regard.

The Commission is also considering whether it would be appropriate to provide for provisional approval upon the filing of an application pending review. The Commission requests comment on the appropriateness of such an approach.

In order to expedite the review of models further, the Commission is proposing to delegate authority to staff to perform the functions described above. As is the case with existing delegations to staff, the Commission would continue to reserve the right to perform these functions itself at any time.

The Commission requests comment on whether additional procedural detail is appropriate. For example, should time frames be specified for completion of any of the functions?

b. Applicability to Multiple Swaps

To the extent that more than one uncleared swap is executed pursuant to an eligible master netting agreement (''EMNA'')[72] between a CSE and a covered counterparty, the CSE would be permitted to calculate initial margin on an aggregate basis with respect to all uncleared swaps governed by such agreement.[73] As explained below, however, only exposures in certain asset classes could be offset. If the agreement covered uncleared swaps entered into before the applicable compliance date, those swaps would have to be included in the calculation.[74]

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

The Commission requests comment on all aspects of the proposed definition of EMNA. In particular, the Commission requests comment on whether the proposal provides sufficient clarity regarding the laws of foreign jurisdictions that provide for limited stays to facilitate the orderly resolution of financial institutions. The Commission also seeks comment regarding whether the provision for a contractual agreement subject by its terms to limited stays under resolution regimes adequately encompasses potential contractual agreements of this nature or whether this provision needs to be broadened, limited, clarified, or modified in some manner.

c. Elements of a Model

The proposal specifies a number of conditions that a model would have to meet to receive Commission approval.[75] They include, among others, the following.

(i) Ten-Day Close-Out Period

The model must calculate potential future exposure using a one-tailed 99 percent confidence interval for an increase in the value of the uncleared swap or netting set of uncleared swaps due to an instantaneous price shock that is equivalent to a movement in all material underlying risk factors, including prices, rates, and spreads, over a holding period equal to the shorter of ten business days or the maturity of the swap.

The required 10-day close-out period assumption is consistent with counterparty credit risk capital requirements for banks. The calculation must be performed directly over a 10-day period. In the context of bank regulatory capital rules, a long horizon calculation (such as 10 days), under certain circumstances, may be indirectly computed by making a calculation over a shorter horizon (such as 1 day) and then scaling the result of the shorter horizon calculation to be consistent with the longer horizon. The proposed rule does not provide this option to covered swap entities using an approved initial margin model. The Commission's understanding is that the rationale for allowing such indirect calculations that rely on scaling shorter horizon calculations has largely been based on computational and cost considerations that were material in the

[68] Proposed Regulation § 23.154(b)(1). *See* BCBS/IOSCO Report at 12: ''any quantitative model that is used for initial margin purposes must be approved by the relevant supervisory authority.''

[69] *Id.*

[70] *Id.*

[71] *Id.*

[72] This term is defined in Proposed Regulation § 23.151.

[73] Proposed Regulation § 23.154(b)(2).

[74] *Id.*

[75] Proposed Regulation § 23.154(b)(3).

past but are much less so in light of advances in computational speeds and reduced computing costs. The Commission seeks comment on whether the option to make use of such indirect calculations has a material effect on the burden of complying with the proposed rule, and whether such indirect methods are appropriate in light of current computing methods and costs.

(ii) Portfolio Offsets

The model may reflect offsetting exposures, diversification, and other hedging benefits for uncleared swaps that are governed by the same EMNA by incorporating empirical correlations within the broad risk categories, provided the covered swap entity validates and demonstrates the reasonableness of its process for modeling and measuring hedging benefits. The categories are agriculture, credit, energy, equity, foreign exchange/ interest rate, metals, and other. 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. The sum of the initial margins calculated for each broad risk category must be used to determine the aggregate initial margin due from the counterparty.

For example, if a CSE entered into two credit swaps and two energy swaps with a single counterparty, the CSE could use an approved initial margin model to perform two separate calculations: the initial margin calculation for the credit swaps and the initial margin calculation for the energy commodity swaps. Each calculation could recognize offsetting and diversification within the credit swaps and within the energy commodity swaps. The result of the two separate calculations would then be summed together to arrive at the total initial margin amount for the four swaps (two credit swaps and two energy commodity swaps).

The Commission believes that the correlations of exposures across unrelated asset categories, such as credit and energy commodities, are not stable enough over time, and, in particular, during periods of financial stress, to be recognized in a regulatory margin model requirement. The Commission further believes that a single commodity asset class is too broad and that the relationship between disparate commodity types, such as aluminum and corn, are not stable enough to warrant hedging benefits within the initial margin model. The Commission seeks comment on this specific treatment of asset classes for initial margin purposes and whether fewer or more distinctions should be made.

The Commission is aware that some swaps may be difficult to classify into one and only one asset class because some swaps may have characteristics that relate to more than one asset class. Under the proposal, the Commission expects that the CSE would make a determination as to which asset class best represents the swap based on a holistic view of the underlying swap. As a specific example, many swaps may have some sensitivity to interest rates even though most of the swap's sensitivity relates to another asset class such as equity or credit. The Commission seeks comment on whether or not this approach is reasonable and whether or not instances in which the classification of a swap into one of the broad asset classes described above is problematic and material. If such instances are material, the Commission seeks comment on alternative approaches to dealing with such swaps.

(iii) Stress Calibration

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

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

The model must use risk factors sufficient to measure all material price risks inherent in the transactions for which initial margin is being calculated. The risk categories must include, but should not be limited to, foreign exchange or interest rate risk, credit risk, equity risk, agricultural commodity risk, energy commodity risk, metal commodity risk, and other commodity risk, as appropriate. For material exposures in significant currencies and markets, modeling techniques must capture spread and basis risk and incorporate a sufficient number of segments of the yield curve to capture differences in volatility and imperfect correlation of rates along the yield curve.

The initial margin model must include all material risks arising from the nonlinear price characteristics of option positions or positions with embedded optionality and the sensitivity of the market value of the positions to changes in the volatility of the underlying rates, prices, or other material risk factors.

(iv) Frequency of Margin Calculation

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

First, the characteristics of the swaps that have a material effect on their risk may change over time. As an example, the credit quality of a corporate reference entity upon which a credit default swap contract is written may undergo a measurable decline.

Second, any change to the composition of the swap portfolio that results in the addition or deletion of swaps from the portfolio would result in a change in the initial margin amount.

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

Fourth, quantitative initial margin models are expected to be maintained and refined on a continuous basis to

reflect the most accurate risk assessment possible with available best practices and methods. As best practice risk management models and methods change, so too may the risk assessments of initial margin models.

(v) Benchmarking

The proposed rule requires that a model used for calculating initial margin requirements be benchmarked periodically against observable margin standards to ensure that the initial margin required is not less than what a CCP would require for similar transactions.[76] This benchmarking requirement is intended to ensure that any initial margin amount produced by a model is subject to a readily observable minimum. It will also have the effect of limiting the extent to which the use of models might disadvantage the movement of certain types of swaps to DCOs by setting lower initial margin amounts for uncleared transactions than for similar cleared transactions.

d. Control Mechanisms

The proposal would require CSEs to implement certain control mechanisms.[77] They include, among others, the following.

The CSE must maintain a risk management unit in accordance with existing Commission Regulation 23.600(c)(4)(i) that reports directly to senior management and is independent from the business trading units.[78] The unit must validate its model before implementation and on an ongoing basis. The validation process must include an evaluation of the conceptual soundness of the model, an ongoing monitoring process to ensure that the initial margin is not less than what a DCO would require for similar cleared products, and back testing.

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

The CSE must have an internal audit function independent of the business trading unit that at least annually assesses the effectiveness of the controls supporting the model. The internal audit function must report its findings to the CSE's governing body, senior management, and chief compliance officer at least annually.

Given the complexity of margin models and the incentives to calculate lower margin amounts, the Commission believes that rigorous internal oversight is necessary to ensure proper functioning.

The Commission seeks comment on all aspects of the proposed standards for models and the proposed levels of regulatory review.

The Commission requests comment on the costs and benefits of the proposed approach. Commenters are urged to quantify the costs and benefits, if practicable. Commenters also may suggest alternatives to the proposed approach where the commenters believe that the alternatives would be appropriate under the CEA.

3. Table-Based Method

a. Method of Calculation

Some CSEs might not have the internal technical resources to develop initial margin models or have simple portfolios for which they want to avoid the complexity of modeling. The table-based method would allow a CSE to calculate its initial margin requirements using a standardized table.[79] The table specifies the minimum initial margin amount that must be collected as a percentage of a swap's notional amount. This percentage varies depending on the asset class of the swap. Except as described below, a CSE would be required to calculate a minimum initial margin amount for each swap and sum up all the minimum initial margin amounts calculated under this section to arrive at the total amount of initial margin. The table is consistent with international standards.[80]

b. Net-to-Gross Ratio Adjustment

The Commission recognizes that using a notional amount measure of initial margin without any adjustment for offsetting exposures, diversification, and other hedging benefits might not accurately reflect the size or risks of a CSE's swap-based positions in many situations. Moreover, not adequately recognizing the benefits of offsets, diversification, and hedging might lead to large disparities between model-based and table-based initial margin requirements. These disparities might give rise to inequities between CSEs that elect to use an approved model and CSEs that rely on the table for computing their respective initial margin requirements.

To address these potential inequities, the Commission is proposing an adjustment to the table-based initial margin requirement. Specifically, the Commission would allow a CSE to calculate a net-to-gross ratio adjustment.[81]

The net-to-gross ratio compares the net current replacement cost of the uncleared portfolio (in the numerator) with the gross current replacement cost of the uncleared portfolio (in the denominator). The net current replacement cost is the cost of replacing the entire portfolio of swaps that is covered under an eligible master netting agreement. The gross current replacement cost is the cost of replacing those swaps that have a strictly positive replacement cost.

For example, consider a portfolio that consists of two uncleared swaps in which the mark-to-market value of the first swap is $10 (*i.e.,* the CSE is owed $10 from its counterparty) and the mark-to-market value of the second swap is –$5 (*i.e.,* the CSE owes $5 to its counterparty). The net current replacement cost is $5 ($10–$5), the gross current replacement cost is $10, and the net-to-gross ratio would be 5/10 or 0.5.[82]

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

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

where:

Gross Initial Margin = the sum of the notional value multiplied by the applicable initial margin requirement percentage from the table A for each uncleared swap in the portfolio

and

[76] Proposed Regulation § 23.154(b)(5).

[77] Proposed Regulation § 23.154(b)(5).

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

[79] Proposed Regulation § 23.154(c).

[80] BCBS/IOSCO Report at Appendix A.

[81] This calculation is set forth in proposed Regulation § 23.154(c)(2).

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

NGR = Net-to-Gross Ratio

The Commission notes that the calculation of the net-to-gross ratio for margin purposes must be applied only to swaps subject to the same EMNA and that the calculation is performed across transactions in disparate asset classes within a single netting agreement. (Thus, all non-cleared swaps subject to the same EMNA can be netted against each other in the calculation of the net-to-gross ratio. By contrast, under a model, netting is only permitted within each asset class). This approach is consistent with the standardized counterparty credit risk capital requirements.

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

The proposed net-to-gross ratio adjustment is consistent with international standards.[83] The proposed table and adjustment are the same as the Prudential Regulators' proposal.

The Commission seeks comment on all aspects of the proposed table-based approach. The Commission notes that the BCBS has recently adopted a new method for the purpose of capitalizing counterparty credit risk.[84] The Commission seeks comment on whether the BCBS's recently adopted standardized approach would represent a material improvement relative to the proposed method that employs the net-to-gross ratio.

The Commission requests comment on the costs and benefits of the proposed approach. Commenters are urged to quantify the costs and benefits, if practicable. Commenters also may suggest alternatives to the proposed approach where the commenters believe that the alternatives would be appropriate under the CEA.

F. Calculation of Variation Margin

1. Means of Calculation

Under the proposal, each CSE would be required to calculate variation margin for itself and for each covered counterparty using a methodology and inputs that to the maximum extent practicable and in accordance with existing Regulation 23.504(b)(4) rely on recently-executed transactions, valuations provided by independent third parties, or other objective criteria.[85] In addition, each CSE would have to have in place alternative methods for determining the value of an uncleared swap in the event of the unavailability or other failure of any input required to value a swap.[86]

2. Control Mechanisms

The proposal would also set forth several control mechanisms.[87] Each CSE would be required to create and maintain documentation setting forth the variation margin methodology with sufficient specificity to allow the counterparty, the Commission, and any applicable Prudential Regulator to calculate a reasonable approximation of the margin requirement independently. Each CSE would be required to evaluate the reliability of its data sources at least annually, and make adjustments, as appropriate. The proposal would permit the Commission to require a CSE to provide further data or analysis concerning the methodology or a data source.

These provisions are consistent with international standards[88] and the Prudential Regulators' proposed rules. The Commission's proposal, however, sets forth more detailed requirements. These requirements are consistent with an approach currently under consideration by an IOSCO working group.

The Commission believes that the accurate valuation of positions and the daily payment of variation margin to remove accrued risk is a critical element in assuring the safety and soundness of CSEs and in preserving the financial integrity of the markets. The Commission believes that its experience with cleared markets[89] coupled with the problems in the uncleared markets noted in section II.A. demonstrates this.

The Commission believes that the proposed provisions avoid potential miscalculations and would allow the variation margin calculations to be monitored and, thereby, forestall potential problems that could exacerbate a crisis. These measures are designed to be prudent safeguards to be used to address weaknesses that may only become apparent over time.

The Commission seeks comment on all aspects of the proposed requirements for calculating variation margin.

The Commission requests comment on the costs and benefits of the proposed approach. Commenters are urged to quantify the costs and benefits, if practicable. Commenters also may suggest alternatives to the proposed approach where the commenters believe that the alternatives would be appropriate under the CEA.

G. Forms of Margin

1. Initial Margin

In general, the Commission believes that margin assets should share the following fundamental characteristics. The assets should be liquid and, with haircuts, hold their value in times of financial stress. The value of the assets should not exhibit a significant correlation with the creditworthiness of the counterparty or the value of the swap portfolio.[90]

Guided by these principles, the Commission is proposing that CSEs may only post or accept certain assets to meet initial margin requirements to or from covered counterparties.[91] These include: U.S. dollars; cash in a currency in which payment obligations under the swap are required to be settled; U.S. Treasury securities; certain securities guaranteed by the U.S.; certain securities issued or guaranteed by the European Central bank, a sovereign entity, or the BIS; certain corporate debt securities; certain equity securities contained in major indices; major currencies,[92] and gold.

These are assets for which there are deep and liquid markets and, therefore, assets that can be readily valued and easily liquidated. This list includes a number of assets that were not included in the 2011 proposal. This is responsive to a number of commenters who expressed concern about the narrowness of that list and the potential that there would be insufficient available collateral.

The Commission notes that any debt security issued by a U.S. Government-sponsored enterprise that is not operating with capital support or another form of direct financial assistance from the U.S. government

[83] BCBS/IOSCO Report at 13.

[84] *See* the Basel Committee on Banking Supervision, "The standardized approach for measuring counterparty credit risk exposures," (March 31, 2014), available at *http://www.bis.org/publ/bcbs279.pdf.*

[85] Proposed Regulation § 23.155(a)(1) and Commission Regulation § 23.504(b)(4).

[86] Proposed Regulation § 23.155(a)(2).

[87] Proposed Regulation § 23.155(b).

[88] BCBS/IOSCO Report at 14–15.

[89] For example, in May 2000, a clearing member defaulted to the New York Clearing Corporation. A significant contributing factor was the lack of a rigorous settlement price procedure which allowed prices in an illiquid market to be mismarked and unrealized losses to accumulate. *See* Report on Lessons Learned from the Failure of Klein & Co, Division of Trading and Markets, Commodity Futures Trading Commission (July 2001).

[90] *See* BCBS/IOSCO Report at 16.

[91] Proposed Regulation § 23.156(a)(1).

[92] Major currencies are defined in Proposed Regulation § 23.151.

would be eligible collateral only if the security met the requirements for corporate debt securities.

The Commission also notes that eligible collateral would include other publicly-traded debt that has been deemed acceptable as initial margin by a Prudential Regulator.[93] The Prudential Regulators have indicated that this would include securities that meet the terms of 12 CFR 1.2(d). That provision states that the issuer of a security must have adequate capacity to meet financial commitments under the security for the projected life of the asset or exposure. It further states an issuer has adequate capacity to meet financial commitments if the risk of default by the obligor is low and the full and timely payment of principal and interest is expected. For example, municipal bonds that meet this standard, as determined by a Prudential Regulator, would be eligible collateral.

Under the proposal, certain assets would be prohibited from use as initial margin.[94] These include any asset that is an obligation of the party providing such asset or an affiliate of that party. These also include instruments issued by bank holding companies, depository institutions and market intermediaries. The use of such assets as initial margin could compound risk. These restrictions reflect the Commission's view that the price and liquidity of securities issued by the foregoing entities are very likely to come under significant pressure during a period of financial stress when a CSE may be resolving a counterparty's defaulted swap position and present an additional source of risk.

The Commission requests comment on the securities subject to this restriction, and, in particular, on whether securities issued by other entities, such as non-bank systemically important financial institutions designated by the Financial Stability Oversight Council, also should be excluded from the list of eligible collateral.

Counterparties that wished to rely on assets that do not qualify as eligible collateral under the proposed rule still would be able to pledge those assets with a lender in a separate arrangement, such as collateral transformation arrangements, using the cash or other eligible collateral received from that separate arrangement to meet the minimum margin requirements.

Moreover, the Commission notes that the proposal would not restrict the types of collateral that could be collected or posted to satisfy margin terms that are bilaterally negotiated above required amounts. For example, if, notwithstanding the $65 million threshold, a CSE decided to collect initial margin to protect itself against the credit risk of a particular counterparty, the CSE could accept any form of collateral.

Except for U.S. dollars and the currency in which the payment obligations of the swap is required, assets posted as required initial margin would be subject to haircuts in order to address the possibility that the value of the collateral could decline during the period that it took to liquidate a swap position in default. The proposed collateral haircuts have been calibrated to be broadly consistent with valuation changes observed during periods of financial stress.

Because the value of noncash collateral and foreign currency may change over time, the proposal would require a CSE to monitor the value of such collateral previously collected to satisfy initial margin requirements and, to the extent the value of such collateral has decreased, to collect additional collateral with a sufficient value to ensure that all applicable initial margin requirements remain satisfied.[95]

The Commission seeks comment on all aspects of the proposed requirements for eligible collateral for initial margin. In particular, the Commission requests comments on whether the list should be expanded or contracted in any way. If so, subject to what terms and conditions?

The Commission requests comment on the costs and benefits of the proposed approach. Commenters are urged to quantify the costs and benefits, if practicable. Commenters also may suggest alternatives to the proposed approach where the commenters believe that the alternatives would be appropriate under the CEA.

2. Variation Margin

The proposal would require that variation margin be paid in U.S. dollars, or a currency in which payment obligations under the swap are required to be settled.[96] When determining the currency in which payment obligations under the swap are required to be settled, a covered swap entity must consider the entirety of the contractual obligation. As an example, in cases where a number of swaps, each potentially denominated in a different currency, are subject to a single master agreement that requires all swap cash flows to be settled in a single currency, such as the Euro, then that currency (Euro) may be considered the currency in which payment obligations are required to be settled.

The proposal is narrower than the 2011 proposal which also permitted U.S. Treasury securities.[97] This change is designed to reinforce the concept that variation margin is paid and to reduce the potential for disputes to arise over the value of assets being used to meet this margin requirement. This proposed change is consistent with regulatory and industry initiatives to improve standardization and efficiency in the OTC derivatives market. For example, in June of 2013, ISDA published the 2013 Standard Credit Support Annex (''SCSA''). The SCSA provides for the sole use of cash as eligible collateral for variation margin. The Commission supports this and other ongoing regulatory and industry efforts at standardization that improve operational efficiency and reduce the differences between the bilateral and cleared OTC derivatives markets.

In this regard, the Commission notes that central counterparties generally require that variation margin be paid in cash. U.S. law applicable to cleared swaps is consistent with this practice. Section 5b(c)(2)(E) of the CEA requires derivatives clearing organizations to ''complete money settlements on a timely basis (but not less frequently than once each business day).'' CFTC Regulation 39.14(a)(1) defines ''settlement'' as, among other things, ''payment and receipt of variation margin for futures, options, and swaps.'' CFTC Regulation 39.14(b) requires that ''except as otherwise provided by Commission order, derivatives clearing organizations shall effect a settlement with each clearing member at least once each business day.''

The Commission believes that this change from the 2011 proposal is appropriate because it better reflects that counterparties to swap transactions generally view variation margin payments as the daily settlement of their exposure(s) to one another. Additionally, limiting variation margin to cash should sharply reduce the potential for disputes over the value of variation margin.

Under this proposed rule, the value of cash paid to satisfy variation margin requirements is not subject to a haircut. Variation margin payments reflect gains and losses on a swap transaction, and payment or receipt of variation margin generally represents a transfer of ownership. Therefore, haircuts are not a

[93] Proposed Regulation § 23.156(a)(1)(ix).

[94] Proposed Regulation § 23.156(a)(2).

[95] Proposed Regulation § 23.156(a)(4).

[96] Proposed Regulation § 23.156(b).

[97] 76 FR 23732 at 23747.

necessary component of the regulatory requirements for cash variation margin.

The proposal is stricter than international standards which do not require that variation margin be in cash.[98] It is the same as the Prudential Regulators' proposal.

The Commission seeks comment on all aspects of the proposed requirements for forms of variation margin.

The Commission requests comment on the costs and benefits of the proposed approach. Commenters are urged to quantify the costs and benefits, if practicable. Commenters also may suggest alternatives to the proposed approach where the commenters believe that the alternatives would be appropriate under the CEA.

H. Custodial Arrangements

The proposal sets forth requirements for the custodial arrangements for initial margin posted for transactions between CSEs and covered counterparties.[99] Each CSE that posts initial margin with respect to an uncleared swap would be mandated to require that all funds or other property that it provided as initial margin be held by one or more custodians that were not affiliates of the CSE or the counterparty. Each CSE that collects initial margin with respect to an uncleared swap would be mandated to require that such initial margin be held at one or more custodians that were not affiliates of the CSE or the counterparty.

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

The proposed rules are consistent with international standards except that international standards would allow rehypothecation under certain circumstances.[100] The proposal is the same as the Prudential Regulators' proposal. The Commission also notes that the European Supervisory Authorities have proposed to prohibit rehypothecation.[101]

The proposed approach is grounded in several provisions of section 4s(e) of the CEA. First, section 4s(e)(3)(A)(i) mandates that margin rules ''help ensure the safety and soundness of [SDs] and [MSPs].'' Maintaining margin collateral at an independent custodian subject to specified terms protects both parties to a transaction by preventing assets from being lost or misused. In particular, a prohibition on rehypothecation enhances safety by avoiding the possibility that a margin asset will be lost because of the failure of a third party who was not a party to the original transaction.

Second, section 4s(e)(3)(C) mandates that margin rules preserve ''the financial integrity of the markets trading swaps'' and ''the stability of the United States financial system.'' Maintaining margin collateral at an independent custodian preserves financial integrity and financial stability by preventing the same asset from supporting multiple positions. If an SD could take collateral posted by a counterparty for one swap and reuse it to margin a second swap with another SD, and that SD could, in turn, do the same, this would increase leverage in the system and create the possibility of a cascade of defaults if one of these firms failed.

Third, section 4s(e)(3)(A) refers to the ''greater risk'' to SDs, MSPs, and the financial system ''arising from the use of swaps that are not cleared.'' It mandates rules ''appropriate for the risk'' associated with uncleared swaps. Margin posted by customers to futures commission merchants (''FCMs'') and by FCMs to DCOs for cleared swaps is subject to segregation requirements.[102] It would be inappropriate to address the greater risk of uncleared swaps with a lesser standard.

The proposed rules can be harmonized with section 4s(l) of the CEA which authorizes counterparties of an SD or an MSP to request that margin be segregated. As discussed above, covered counterparties pose risk to the financial system. The primary purpose of the proposed custodial arrangements is preservation of the financial integrity of the markets and the U.S. financial system although the arrangements will also have the effect of protecting individual market participants. Section 4s(l) is not made superfluous by the proposed rules because it would still be available for financial end users with less than material swaps exposure, for financial end users that post initial margin in excess of the required amount, and for non-financial end users that post initial margin. Such entities would be posting margin, by agreement, with SDs or MSPs. Section 4s(l) would provide them with an opportunity to obtain additional protection if they desired.

The Commission previously adopted rules implementing section 4s(l).[103] The Commission is now proposing to amend those rules to reflect the approach described above where segregation of initial margin would be mandatory under certain circumstances. The Commission is proposing three changes.

First, the proposal would amend § 23.701(a)(1) to read as follows: Notify each counterparty to such transaction that the counterparty has the right to require that any Initial Margin the counterparty provides in connection with such transaction be segregated in accordance with §§ 23.702 and 23.703 *except in those circumstances where segregation is mandatory pursuant to § 23.157.* (New language in italics.)

Second, the proposal would amend § 23.701(d) to read as follows: Prior to confirming the terms of any such swap, the swap dealer or major swap participant shall obtain from the counterparty confirmation of receipt by the person specified in paragraph (c) of this section of the notification specified in paragraph (a) of this section, and an election, *if applicable,* to require such segregation or not. The swap dealer or major swap participant shall maintain such confirmation and such election as business records pursuant to § 1.31 of this chapter. (New language in italics.)

Third, the proposal would amend § 23.701(f) to read as follows: A counterparty's election, *if applicable,* to require segregation of Initial Margin or not to require such segregation, may be changed at the discretion of the counterparty upon written notice delivered to the swap dealer or major swap participant, which changed election shall be applicable to all swaps entered into between the parties after such delivery. (New language in italics.)

The Commission seeks comment on all aspects of the proposed requirements regarding custodial arrangements.

The Commission requests comment on the costs and benefits of the proposed approach. Commenters are urged to quantify the costs and benefits, if practicable. Commenters also may suggest alternatives to the proposed approach where the commenters believe that the alternatives would be appropriate under the CEA.

I. Documentation

The proposal sets forth documentation requirements for CSEs.[104] For uncleared swaps between a CSE and a covered counterparty, the

[98] BCBS/IOSCO Report at 14–15. The international standards do not distinguish between initial margin and variation margin in discussing eligible assets.

[99] Proposed Regulation § 23.157.

[100] BCBS/IOSCO Report at 19–20.

[101] *See* ''Draft Regulatory Technical Standards on Risk-mitigation Techniques for OTC-derivative Contracts Not Cleared by a CCP under Article 11(15) of Regulation (EU) No. 648/2012,'' pp. 11, 42–43 (April 14, 2014).

[102] Section 4d(f) of the CEA.

[103] Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy, 78 FR 66621 (Nov. 6, 2013).

[104] Proposed Regulation § 23.158.

documentation would be required to provide the CSE with the contractual right and obligation to exchange initial margin and variation margin in such amounts, in such form, and under such circumstances as are required by § 23.150 through § 23.160 of this part. For uncleared swaps between a CSE and a non-financial entity, the documentation would be required to specify whether initial and/or variation margin will be exchanged and, if so, to include the information set forth in the rule. That information would include the methodology and data sources to be used to value positions and to calculate initial margin and variation margin, dispute resolution procedures, and any margin thresholds.

The international standards do not contain a specific requirement for documentation. The requirements in the Prudential Regulators' proposal are consistent with the Commission proposal but the Commission proposal contains additional elements.

The Commission proposal contains a cross-reference to an existing Commission rule which already imposes documentation requirements on SDs and MSPs.[105] Consistent with that rule, the proposal would apply documentation requirements not only to covered counterparties but also to non-financial end users. Having comprehensive documentation in advance concerning these matters would allow each party to a swap to manage its risks more effectively throughout the life of the swap and to avoid disputes regarding issues such as valuation during times of financial turmoil. This would benefit not only the CSE but the non-financial end user as well.

The Commission seeks comment on all aspects of the proposed requirements for documentation.

The Commission requests comment on the costs and benefits of the proposed approach. Commenters are urged to quantify the costs and benefits, if practicable. Commenters also may suggest alternatives to the proposed approach where the commenters believe that the alternatives would be appropriate under the CEA.

J. Implementation Schedule

The proposed rules establish the following implementation schedule: [106]

December 1, 2015 for the requirements in § 23.153 for variation margin;

December 1, 2015 for the requirements in § 23.152 for initial margin for any uncleared swaps where both (i) the CSE combined with all its affiliates and (ii) its counterparty combined with all its affiliates, have an average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange forwards, and foreign exchange swaps in June, July, and August 2015 that exceeds $4 trillion, where such amounts are calculated only for business days;

December 1, 2016 for the requirements in § 23.152 for initial margin for any uncleared swaps where both (i) the CSE combined with all its affiliates and (ii) its counterparty combined with all its affiliates, have an average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange forwards, and foreign exchange swaps in June, July and August 2016 that exceeds $3 trillion, where such amounts are calculated only for business days;

December 1, 2017 for the requirements in § 23.152 for initial margin for any uncleared swaps where both (i) the CSE combined with all its affiliates and (ii) its counterparty combined with all its affiliates have an average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange forwards, and foreign exchange swaps in June, July and August 2017 that exceeds $2 trillion, where such amounts are calculated only for business days;

December 1, 2018 for the requirements in § 23.152 for initial margin for any uncleared swaps where both (i) the CSE combined with all its affiliates and (ii) its counterparty combined with all its affiliates have an average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange forwards, and foreign exchange swaps in June, July and August 2018 that exceeds $1 trillion, where such amounts are calculated only for business days;

December 1, 2019 for the requirements in § 23.152 for initial margin for any other CSE with respect to uncleared swaps entered into with any other counterparty.

This extended schedule is designed to give market participants ample time to develop the systems and procedures necessary to exchange margin and to make arrangements to have sufficient assets available for margin purposes. The requirements would be phased-in in steps from the largest covered parties to the smallest.

Variation margin would be implemented on the first date for two reasons. First, a significant part of the market currently pays variation margin so full implementation would be less disruptive. Second, the elimination of current exposures through the daily use of variation margin would be an effective first step in enhancing the safety and soundness of market participants and the financial integrity of the markets.

The proposal is consistent with international standards except for the 8 billion euro threshold, discussed above, that would apply starting Dec. 1, 2019 under the international standards.[107] The proposal is the same as the proposal of the Prudential Regulators.

The Commission requests comment on the costs and benefits of the proposed approach. Commenters are urged to quantify the costs and benefits, if practicable. Commenters also may suggest alternatives to the proposed approach where the commenters believe that the alternatives would be appropriate under the CEA.

K. Request for Comment

The Commission requests comment on all aspects of the proposed rules. In particular, as noted above, the Commission invites comments on the potential costs and benefits of each provision. Commenters are urged to quantify the costs and benefits, if practicable. Commenters also may suggest alternatives to the proposed approach where the commenters believe that the alternatives would be appropriate under the CEA.

III. Advance Notice of Proposed Rulemaking on the Cross-Border Application of the Proposed Margin Rules

A. Alternative Options

Section 2(i) of the CEA [108] provides that the provisions of the CEA relating to swaps that were enacted by the Wall Street Transparency and Accountability Act of 2010 (including any rule prescribed or regulation promulgated under that Act, shall not apply to activities outside the United States unless those activities (1) have a direct and significant connection with activities in, or effect on, commerce of the United States or (2) contravene such rules or regulations as the Commission may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision of this chapter that was enacted by the Wall Street Transparency and Accountability Act of 2010.

Section 2(i) provides the Commission with express authority over activities outside the United States relating to swaps when certain conditions are met.

[105] Commission Regulation § 23.504.

[106] Proposed Regulation § 23.160.

[107] BCBS/IOSCO Report at 23–24.

[108] 7 U.S.C. 2(i).

As discussed in part I.A. above, the primary purpose of the margin provision in section 4s(e) is to address risk to SDs, MSPs, and the financial system arising from uncleared swaps. Given the risk-mitigation function of the margin rules for uncleared swaps, the Commission believes that the rules should apply on a cross-border basis in a manner that effectively addresses risks to the registered SD or MSP. At the same time, it may be appropriate, consistent with principles of international comity and statutory objectives underlying the margin requirements, to allow SDs and MSPs to satisfy the margin requirements by complying with a comparable regime in the relevant foreign jurisdiction, or to not apply the margin requirements under certain circumstances.

In this Advance Notice of Proposed Rulemaking, the Commission is considering three approaches to applying the margin requirements to Commission-registered SDs and MSPs, consistent with section 2(i): (1) A transaction-level approach that is consistent with the Commission's cross-border guidance (''Guidance Approach''); [109] (2) the Prudential Regulators' approach; and (3) an entity-level approach (''Entity-Level Approach''). The general framework for each of these approaches is described below. The Commission is not endorsing at this time any particular approach and invites comments on all aspects of the three approaches and welcomes any suggestions on other possible approaches. The Commission may propose and ultimately adopt one of the three approaches with modifications.

1. The Cross-Border Guidance Approach

Under the first option, the Commission would apply the margin requirements consistent with the Cross-Border Guidance. The Commission stated in the Guidance that it would generally treat the margin requirements (for uncleared swaps) as a transaction-level requirement. Consistent with the rationale stated in the Guidance, under this approach, the proposed margin requirements would apply to a U.S. SD/MSP (other than a foreign branch of a U.S. bank that is a SD/MSP) for all of their uncleared swaps (as applicable), irrespective of whether the counterparty is a U.S. person [110] or not, without substituted compliance.

On the other hand, under this approach, the proposed margin requirements would apply to a non-U.S. SD/MSP (whether or not it is a ''guaranteed affiliate'' [111] or an ''affiliate conduit'' [112]) only with respect to its uncleared swaps with a U.S. person counterparty (including a foreign branch of U.S. bank that is a SD/MSP) and a non-U.S. counterparty that is guaranteed by a U.S. person or is an affiliate conduit. Where the counterparty is a guaranteed affiliate or is an affiliate conduit, the Commission would allow substituted compliance (*i.e.,* the non-U.S. SD/MSP would be permitted to comply with the margin requirements of its home country's regulator if the Commission determines that such requirements are comparable to the Commission's margin requirements).

For trades between a non-U.S. SD/MSP (whether or not it is a guaranteed affiliate or an affiliate conduit) and a non-U.S. counterparty that is not a guaranteed affiliate or affiliate conduit, the Commission would not apply the margin requirements to such swaps.

In the case of a foreign branch of a U.S. bank that is a SD/MSP, the proposed margin requirements would apply with respect to all of its uncleared swaps, regardless of the counterparty. However, where the counterparty to the trade is another foreign branch of a U.S. bank that is a SD/MSP or is a non-U.S. person counterparty (whether or not it is a guaranteed affiliate or an affiliate conduit), the Commission would allow substituted compliance (*i.e.,* the foreign branch of a U.S. bank that is a SD/MSP would be permitted to comply with the margin requirements of the regulator in the foreign jurisdiction where the foreign branch is located if the Commission determines that such requirements are comparable to the Commission's margin requirements).[113]

Below is a summary of how the margin requirements would apply under the Cross-Border Guidance Approach.

	U.S. person (other than Foreign Branch of U.S. Bank that is a Swap Dealer or MSP)	Foreign Branch of U.S. Bank that is a Swap Dealer or MSP	Non-U.S. person guaranteed by, or affiliate conduit of, a U.S. person	Non-U.S. person *not* guaranteed by, and not an affiliate conduit of, a U.S. person
U.S. Swap Dealer or MSP (including an affiliate of a non-U.S. person).	Apply	Apply	Apply	Apply
Foreign Branch of U.S. Bank that is a Swap Dealer or MSP.	Apply	Substituted Compliance.	Substituted Compliance.	Substituted Compliance
Non-U.S. Swap Dealer or MSP (including an affiliate of a U.S. person).	Apply	Substituted Compliance.	Substituted Compliance.	Do Not Apply

[109] Interpretative Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 FR 45292 (July 26, 2013) (''Guidance''). The Commission addressed, among other things, how the swap provisions in the Dodd-Frank Act (including the margin requirement for uncleared swaps) would apply on a cross-border basis. In this regard, the Commission stated that as a general policy matter it would apply the margin requirement as a transaction-level requirement.

[110] The scope of the term ''U.S. person'' as used in the Cross-Border Guidance Approach and the Entity-Level Approach would be the same as under the Guidance. *See* Guidance at 45316–45317 for a summary of the Commission's interpretation of the term ''U.S. person.''

[111] Under the Guidance, *id.* at 45318, the term ''guaranteed affiliate'' refers to a non-U.S. person that is an affiliate of a U.S. person and that is guaranteed by a U.S. person. The scope of the term ''guarantee'' under the Cross-Border Guidance Approach and the Entity-Level Approach would be the same as under note 267 of the Guidance and accompanying text.

[112] Under the Guidance, *id.* at 45359, the factors that are relevant to the consideration of whether a person is an ''affiliate conduit'' include whether: (i) The non-U.S. person is majority-owned, directly or indirectly, by a U.S. person; (ii) the non-U.S. person controls, is controlled by, or is under common control with the U.S. person; (iii) the non-U.S. person, in the regular course of business, engages in swaps with non-U.S. third party(ies) for the purpose of hedging or mitigating risks faced by, or to take positions on behalf of, its U.S. affiliate(s), and enters into offsetting swaps or other arrangements with such U.S. affiliate(s) in order to transfer the risks and benefits of such swaps with third-party(ies) to its U.S. affiliates; and (iv) the financial results of the non-U.S. person are included in the consolidated financial statements of the U.S. person. Other facts and circumstances also may be relevant.

[113] Under a limited exception, where a swap between the foreign branch of a U.S. SD/MSP and a non-U.S. person (that is not a guaranteed or conduit affiliate) takes place in a foreign jurisdiction other than Australia, Canada, the European Union, Hong Kong, Japan, or Switzerland, the counterparties generally may comply only with the transaction-level requirements in the foreign jurisdiction where the foreign branch is located if the aggregate notional value of all the swaps of the U.S. SD's foreign branches in such countries does not exceed 5% of the aggregate notional value of all of the swaps of the U.S. SD, and the U.S. person maintains records with supporting information for the 5% limit and can identify, define, and address any significant risk that may arise from the non-application of the Transaction-Level Requirements.

2. Prudential Regulators' Approach

Under the second option, the Commission would adopt the Prudential Regulators' approach to cross-border application of the margin requirements.[114] Under the Prudential Regulators' proposal, the Prudential Regulators would not assert authority over trades between a non-U.S. SD/MSP [115] that is not guaranteed by a U.S. person and either a (i) non-U.S. SD/MSP that is not guaranteed by a U.S. person or (ii) a non-U.S. person that is not guaranteed by a U.S. person. The Prudential Regulators' approach is generally consistent with the Entity-Level Approach described below, with the exception of the application of the margin requirements to certain non-U.S. SD/MSPs.

However, the Prudential Regulators' proposal in this regard would be consistent with the Commission's Cross-Border Guidance Approach to margin requirements with respect to a trade between a non-U.S. SD/MSP and a non-U.S. person that is not guaranteed by a U.S. person. But under the definition of ''foreign covered swap entity'' in the Prudential Regulators' approach, a non-U.S. SD/MSP controlled by a U.S. person would not be a foreign covered swap entity, and thus, would not qualify for the exclusion from the margin requirement. In addition, the Prudential Regulators' proposal incorporates a ''control'' test for purposes of determining whether a registered SD/MSP (or in the Prudential Regulators' proposal, a ''covered swap entity'') is not a ''foreign'' entity.

3. Entity-Level Approach

Under the third option, the Commission would treat the margin requirements as an entity-level requirement. Under this Entity-Level Approach, the Commission would apply its cross-border rules on margin on a firm-wide level, irrespective of whether the counterparty is a U.S. person.[116] At the same time, in recognition of international comity, the Commission is considering, where appropriate, to allow SDs/MSPs to satisfy the margin requirements by complying with a comparable regime in the relevant foreign jurisdiction, as described in the table below. This approach would be intended to address the concern that the source of the risk to a firm—given that the non-U.S. SD/MSP has sufficient contact with the United States to require registration as an SD/MSP—is not confined to its uncleared swaps with U.S. counterparties or to its uncleared swaps executed within the United States. A firm's losses in uncleared swaps with non-U.S. counterparties, for example, could have a direct and significant impact on the firm's financial integrity and on the U.S. financial system.

Counterparty A	Counterparty B	Applicable requirements
1. U.S. SD/MSP	U.S. person	U.S. (All).
2. U.S. SD/MSP	Non U.S. person guaranteed by a U.S. person	U.S. (All).
3. Non-U.S. SD/MSP guaranteed by a U.S. person.	U.S. person not registered as an SD/MSP	U.S. (All).
4. Non-U.S. SD/MSP guaranteed by a U.S. person.	Non-U.S. person guaranteed by a U.S. person	U.S. (All).
5. U.S. SD/MSP	Non-U.S. person not guaranteed by a U.S. person.	U.S. (Initial Margin collected by U.S. SD/MSP). Substituted Compliance (Initial Margin collected by non-U.S. person not guaranteed by a U.S. person). U.S. (Variation Margin).
6. Non-U.S. SD/MSP guaranteed by a U.S. person.	Non-U.S. person not guaranteed by a U.S. person.	U.S. (Initial Margin collected by non-U.S. SD/MSP guaranteed by a U.S. person). Substituted Compliance (Initial Margin collected by non-U.S. person not guaranteed by a U.S. person). U.S. (Variation Margin).
7. Non-U.S. SD/MSP not guaranteed by a U.S. person.	U.S. person not registered as an SD/MSP	Substituted Compliance (All).
8 Non-U.S. SD/MSP not guaranteed by a U.S. person.	Non-U.S. person guaranteed by a U.S. person	Substituted Compliance (All).
9. Non-U.S. SD/MSP not guaranteed by a U.S. person.	Non-U.S. SD/MSP not guaranteed by a U.S. person.	Substituted Compliance (All).
10. Non-U.S. SD/MSP not guaranteed by a U.S. person.	Non-U.S. person not registered as an SD/MSP and not guaranteed by a U.S. person.	Substituted Compliance (All).

B. Questions

In this Advance Notice of Proposed Rulemaking, the Commission requests comment on all aspects of these options to the cross-border application of the margin requirements. In particular, the Commission is interested in comments relating to the costs and benefits of the various approaches so that it can take that into consideration when developing proposed rules relating to the cross-border application of the margin rules. Commenters are encouraged to address, among other things, the following questions:

1. Under the Guidance Approach and Prudential Regulators Approach, certain trades involving a non-U.S. SD/MSP would be excluded from the Commission's margin rules. The Commission seeks comment on whether this exclusion is over- or under-inclusive, and if so, please explain why.

2. Each of the options provides for substituted compliance under certain situations. In light of the equal or greater supervisory interest of the foreign regulator in certain circumstances, the Commission is seeking comment on whether the scope of substituted compliance under each option is appropriate.

[114] *See* Section 9 of Margin and Capital Requirements for Covered Swap Entities, 12 CFR Part 237 (Sept. 3, 2014), *available at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20140903c1.pdf.*

[115] Under the Prudential Regulators' approach, if an SD/MSP is under the control of a U.S. person, it would not be considered a non-U.S. SD/MSP.

[116] However, substituted compliance may be available under certain circumstances, as described in the Guidance for entity-level requirements.

3. The Commission is seeking comments on whether, in defining a non-U.S. covered swap entity, it should use the concept of ''control,'' in determining whether a covered swap entity is (or should be treated as) a non-U.S. covered swap entity. If the Commission uses a concept of control, should it be the same as that used by the Prudential Regulators, or should it be different?

4. In the Commission's view, it is the substance, rather than the form, of an agreement, arrangement or structure that should determine whether it should be considered a ''guarantee.'' The Commission invites comment on how the term ''guarantee'' should be construed or defined in the context of these margin rules. For example, should the definition cover the multitude of different agreements, arrangements and structures that transfer risk directly back to the United States with respect to financial obligations arising out of a swap? Should the definition cover such agreements, arrangements and structures even if they do not specifically reference the relevant swap or affirmatively state that it does not apply to such swap? Should the definition cover agreements, arrangements and structures even if the other party to the swap terminates, waives, or revokes the benefit of such agreements, arrangements or structures?

5. The Commission seeks comments on the costs and benefits of harmonization with the Prudential Regulators' proposal.

6. The Commission invites commenters to comment in particular on the benefits of each of the approaches with respect to the statutory goal of protecting the financial system against the risks associated with uncleared swaps.

7. Given that some foreign jurisdictions may not adopt comparable margin requirements, the Commission seeks comment on the costs and benefits of not requiring substituted compliance in emerging markets with respect to certain transactions and what might be an appropriate threshold percentage of a swap portfolio of participants or other standard for a de minimis level. In particular, the Commission is seeking comment on potential competitive impacts. Commenters are encouraged to quantify, if practical.

8. The Commission seeks comment, including quantitative estimates in terms of notional volumes of swap activity, about how the different cross-border alternatives may impact the competitive landscape between U.S. entities and non-U.S. entities participating in swap markets. Specifically, the Commission seeks quantitative estimates of costs of transacting uncleared swaps with each category of counterparties, and/or access specific geographical markets, under each of the different alternatives. Commission seeks quantitative estimates of such impact on the ability of the affected market participants (who might be unable to access specific markets or counterparties) to hedge their risks using uncleared swaps. As the proposed margins on uncleared swaps are designed to strengthen market integrity, the Commission seeks comments on potential impact of each of these alternatives on market participants' business models and trading strategies that could potentially compromise this policy goal. Commenters are encouraged to quantify and provide institutional details.

9. The Commission is seeking comments on how the different alternatives impact price discovery? Commenters are encouraged to quantify, if practical. For instance, will different cross-border alternatives impact the ability of different categories of market participants, as contemplated in these alternatives, to transact uncleared swaps with each other? The Commission seeks quantitative estimates of such impact on transacted volumes and the pricing of uncleared swaps.

10. The Commission is seeking comments on the relative costs and difficulty of compliance associated with each of the three approaches. Is one of the approaches preferable to the others in this regard?

11. The Commission is seeking comments on the impact of each of the three approaches on a SD/MSP's risk management practices.

IV. Related Matters

A. Regulatory Flexibility Act

The Regulatory Flexibility Act (''RFA'') requires that agencies consider whether the regulations they propose will have a significant economic impact on a substantial number of small entities.[117] The Commission previously has established certain definitions of ''small entities'' to be used in evaluating the impact of its regulations on small entities in accordance with the RFA.[118] The proposed regulations would affect SDs and MSPs and their counterparties to uncleared swaps. As the only counterparties of SDs and MSPs to uncleared swaps can be other SDs, MSPs or ECPs, the following RFA will only discuss these entities.

The Commission previously has determined that SDs and MSPs are not small entities for purposes of the RFA.[119] The Commission also previously has determined that ECPs are not small entities for RFA purposes.[120] Because ECPs are not small entities, and persons not meeting the definition of ECP may not conduct transactions in uncleared swaps, the Commission need not conduct a regulatory flexibility analysis respecting the effect of these proposed rules on ECPs.

Accordingly, this proposed rule will not have a significant economic effect on any small entity. Therefore, the Chairman, on behalf of the Commission, hereby certifies pursuant to 5 U.S.C. 605(b) that the proposed regulations will not have a significant economic impact on a substantial number of small entities.

B. Paperwork Reduction Act

The Paperwork Reduction Act of 1995 (''PRA'') [121] imposes certain requirements on Federal agencies, including the Commission, in connection with their conducting or sponsoring any collection of information, as defined by the PRA. This proposed rulemaking would result in the collection of information requirements within the meaning of the PRA, as discussed below. The proposed rulemaking contains collections of information for which the Commission has previously received control numbers from OMB. The titles for these collections of information are ''Regulations and Forms Pertaining to Financial Integrity of the Market Place, OMB control number 3038–0024'' and ''Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, OMB control number 3038–0088.''

The collections of information that are proposed by this rulemaking are necessary to implement section 4s(e) of the CEA, which expressly requires the Commission to adopt rules governing margin requirements for SDs and MSPs. If adopted, responses to this collection of information would be mandatory. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number.

1. Clarification of Collection 3038–0088

This proposed rulemaking clarifies the existing collection of information found in OMB Control Number 3038–

[117] 5 U.S.C. 601 *et seq.*

[118] 47 FR 18618 (Apr. 30, 1982).

[119] *See* 77 FR 30596, 30701 (May 23, 2012).

[120] *See* 66 FR 20740, 20743 (April 25, 2001).

[121] 44 U.S.C. 3501 *et seq.*

0088.[122] Regulation 23.151 defines terms used in the proposed rule, including the definition of ''eligible master netting agreement,'' which provides that a CSE that relies on the agreement for purpose of calculating the required margin must (1) conduct sufficient legal review of the agreement to conclude with a well-founded basis that the agreement meets specified criteria and (2) establish and maintain written procedures for monitoring relevant changes in the law and to ensure that the agreement continues to satisfy the requirements of this section. The term ''eligible master netting agreement'' is used elsewhere in the proposed rule to specify instances in which a CSE may (1) calculate variation margin on an aggregate basis across multiple non-cleared swaps and (2) calculate initial margin requirements under an initial margin model for one or more swaps.

Proposed Regulations §§ 23.152(c) and 23.153(d) specify that a CSE shall not be deemed to have violated its obligation to collect or post initial and variation margin, respectively, from or to a counterparty if the CSE has made the necessary efforts to collect or post the required margin, including the timely initiation and continued pursuit of formal dispute resolution mechanisms, or has otherwise demonstrated upon request to the satisfaction of the Commission that it has made appropriate efforts to collect or post the required margin.

Proposed Regulation § 23.154 establishes standards for initial margin models. These standards include (1) a requirement that a CSE review its initial margin model annually (§ 23.154(b)(4)); (2) a requirement that the covered swap entity validate its initial margin model initially and on an ongoing basis, describe to the Commission any remedial actions being taken, and report internal audit findings regarding the effectiveness of the initial margin model to the CSE's board of directors or a committee thereof (§§ 23.154(b)(5)(ii) through 23.154(b)(5)(iv)); (3) a requirement that the CSE adequately documents all material aspects of its initial margin model (§ 23.154(b)(6)); and (4) a requirement that the CSE adequately documents internal authorization procedures, including escalation procedures that require review and approval of any change to the initial margin calculation under the initial margin model, demonstrable analysis that any basis for any such change is consistent with the requirements of this section, and independent review of such demonstrable analysis and approval (§ 23.154(b)(7)).

Proposed Regulation § 23.155(b) requires a covered swap entity to create and maintain documentation setting forth the variation margin methodology, evaluate the reliability of its data sources at least annually, and make adjustments, as appropriate, and provides that the Commission at any time may require a covered swap entity to provide further data or analysis concerning the methodology or a data source.

Proposed Regulation § 23.158 requires a covered swap entity to execute trading documentation with each counterparty that is either a swap entity or financial end user regarding credit support arrangements that (1) provides the contractual right to collect and post initial margin and variation margin in such amounts, in such form, and under such circumstances as are required; and (2) specifies the methods, procedures, rules, and inputs for determining the value of each non-cleared swap or non-cleared security-based swap for purposes of calculating variation margin requirements, and the procedures for resolving any disputes concerning valuation. The reporting and recordkeeping requirements of proposed Regulation § 23.158, proposed Regulations § 23.154(b)(4) through (7), and proposed Regulation § 23.155(b) are contained in the provisions of Commission Regulations 23.500 through 23.506, which were adopted on September 11, 2012, and part of OMB Control No. 3038–0088.[123] Thus, the requirements in this proposal that are subject to collection 3038–0088 were previously addressed by the Commission in adopting the swap documentation trading requirements and simply further clarified in this proposal.

To be sure, Commission Regulation § 23.504(b) requires an SD or MSP to maintain written swap trading relationship documentation that must include all terms governing the trading relationship between the SD or MSP and its counterparty, and Commission Regulation § 23.504(d) requires that each SD and MSP maintain all documents required to be created pursuant to Commission Regulation 23.504. Also, Commission Regulation § 23.502(c) requires each SD and MSP to notify the Commission and any applicable Prudential Regulator of any swap valuation dispute in excess of $20 million if not resolved in specified timeframes. Accordingly, this proposed rulemaking, specifically the requirements found in proposed Regulation § 23.154(b)(4) through (7), proposed Regulations §§ 23.155(b) and 23.158, would not impact the burden estimates currently provided for in OMB Control No. 3038–0088.

2. Revisions to Collection 3038–0024

Collection 3038–0024 is currently in force with its control number having been provided by OMB. The proposal would revise collection 3038–0024 as discussed below.

Proposed Regulation § 23.154(b)(1) requires CSEs that wish to use initial margin models to obtain the Commission's approval, and to demonstrate to the Commission that the models satisfy standards established in § 23.154.[124] These standards include (1) a requirement that a CSE receive approval from the Commission based on a demonstration that the initial margin model meets specific requirements (§ 23.154(b)(1)); (2) a requirement that a CSE notify the Commission in writing 60 days before extending the use of the model to additional product types, making certain changes to the initial margin model, or making material changes to modeling assumptions (§ 23.154(b)(1)); and (3) a variety of quantitative requirements, including requirements that the CSE validate and demonstrate the reasonableness of its process for modeling and measuring hedging benefits, demonstrate to the satisfaction of the Commission that the omission of any risk factor from the calculation of its initial margin is appropriate, demonstrate to the satisfaction of the Commission that incorporation of any proxy or approximation used to capture the risks of the covered swap entity's non-cleared swaps or non-cleared security-based swaps is appropriate, periodically review and, as necessary, revise the data used to calibrate the initial margin model to ensure that the data incorporate an appropriate period of significant financial stress (§ 23.154(b)(3)).

The requirement of proposed Regulation § 23.154(b)(1) that a CSE

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

[123] 77 FR 55904 (Sept. 12, 2012).

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

must obtain the Commission's approval to use an initial margin model by submitting documentation demonstrating that the initial margin model meets the standards set forth in § 23.154, and the requirement that a CSE must provide the Commission with written notice 60 days prior to extending the use of the initial margin model to additional product types or making material changes to the model would result in revisions to the collection.

Currently, there are approximately 100 SDs and MSPs provisionally registered with the Commission. The Commission further estimates that approximately 60 of the SDs and MSPs will be subject to the Commission's margin rules as they are not subject to a Prudential Regulator. The Commission further estimates that all SDs and MSPs will seek to obtain Commission approval to use models for computing initial margin requirements. The Commission estimates that the initial margin model requirements will impose an average of 240 burden hours per registrant.

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

Number of registrants: 60.

Frequency of collection: Initial submission and periodic updates.

Estimated annual responses per registrant: 1.

Estimated aggregate number of annual responses: 60.

Estimated annual hour burden per registrant: 240 hours.

Estimated aggregate annual hour burden: 14,400 hours [60 registrants × 240 hours per registrant].

3. Information Collection Comments

The Commission invites the public and other Federal agencies to comment on any aspect of the reporting burdens discussed above. Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments in order to: (1) Evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the Commission, including the information will have practical utility; (2) evaluate the accuracy of the Commission's estimate of the burden of the proposed collection of information; (3) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (4) minimize the burden of the collection of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Comments may be submitted directly to the Office of Information and Regulatory Affairs, by fax at (202) 395–6566 or by email at *OIRAsubmissions@omb.eop.gov.* Please provide the Commission with a copy of submitted comments so that all comments can be summarized and addressed in the final rule preamble. Refer to the **ADDRESSES** section of this notice of proposed rulemaking for comment submission instructions to the Commission. A copy of the supporting statements for the collections of information discussed above may be obtained by visiting *RegInfo.gov.* OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication of this document in the **Federal Register**. Therefore, a comment is best assured of having its full effect if OMB receives it within 30 days of publication.

C. Cost-Benefit Considerations

1. Introduction

Section 15(a) of the CEA requires the Commission to consider the costs and benefits of its actions before promulgating a regulation under the CEA or issuing certain orders.[125] Section 15(a) further specifies that the costs and benefits shall be evaluated in light of five broad areas of market and public concern: (1) Protection of market participants and the public; (2) efficiency, competitiveness, and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations. The Commission considers the costs and benefits resulting from its discretionary determinations with respect to the section 15(a) factors.

The Commission recognizes that there is an inherent trade-off involved in setting minimum collateral standards. Such standards could increase margin requirements, which in turn would require market participants to post additional collateral. Posting additional collateral may result in opportunity costs in terms of lost returns from investing the funds in collateral, or in interest expenses incurred to raise additional funds. Such costs may reduce the investment returns for market participants posting collateral. On the other hand, minimum collateral standards help to mitigate counterparty credit risk. This is achieved by requiring market participants to post collateral that is sufficient to cover potential losses from default most of the time. The potential reduction in investment returns for market participants posting collateral might also be offset to some degree by improvements in pricing as a result of the reduction in risk of the swap. The reduction in counterparty credit risk from the posting of collateral may result in tighter spreads quoted by liquidity providers.[126] From a regulatory perspective, minimum collateral standards introduce a trade-off between potentially lowering anticipated returns for market participants and lowering systemic risk from counterparty defaults. A substantial loss from a default might induce a cascade of defaults in a financial network, and perhaps, induce a liquidity crisis and the seizing up of parts of the financial system. In developing this proposal, the Commission has sought to reduce the potential lowering of investment returns of market participants by allowing them to use approved models to set margin collateral for certain swap transactions while still guarding against the dangers of systemic risk from counterparty defaults, along with other parts of the rule.

2. Rule Summary

This proposed rulemaking is a re-proposal of prior CFTC proposed rulemaking.[127] It is the result of a working group consultation paper issued by BCBS–IOSCO on margin for OTC-derivative contracts not cleared by a CCP (uncleared derivatives).[128] This proposed rulemaking would implement the new statutory framework of section 4s(e) of the CEA, added by section 731 of the Dodd-Frank Act, which requires the Commission to adopt capital and initial and variation margin requirements for certain SDs and MSPs. Generally, the proposed rule would require the exchange (collection, posting, and payment) of margin by SDs and MSPs for trades with other SDs, MSPs and financial end-users. Initial margin is required to be held at third-party custodians with no rehypothecation. These CSEs would not be required to collect margin from or post margin to commercial end-users.

Generally, the CFTC's margin rules will apply to a SD or MSP whenever

[125] 7 U.S.C. 19(a).

[126] Posting collateral for swap transactions may result in other changes in the relationship between the CSE and counterparty instead of just pricing terms of swap contracts. For instance, bank CSEs might lower the required minimum balance on checking accounts that counterparty maintain with the bank, instead.

[127] *See* 76 FR 23732 (April 28, 2011).

[128] Margin requirements for non-centrally cleared derivatives at *http://www.bis.org/publ/bcbs261.pdf,* September 2013. The proposed rule establishes minimum standards for margin requirements for non-centrally cleared derivatives as agreed by BIS and IOSCO.

there is no Prudential Regulator for that covered swap entity.[129] The CFTC's margin rules will apply to swaps that are not cleared and that are executed subsequent to applicable compliance dates set out below, based on an entity's level of uncleared swaps activity during a particular period.

Generally, a CSE must collect IM from a counterparty that is (i) a swap entity, or (ii) a financial end-user with material swaps exposure ($3 billion notional during June, July and August of the previous year) in an amount that is no less than the greater of: (i) Zero (0) or (ii) the IM collection amount for such swap less the IM threshold amount ($65 million—not including any portion of the IM threshold amount already applied by the covered swap entity or its affiliates to other swaps with the counterparty or its affiliates).

Generally, a CSE must post IM for any swap with a counterparty that is a financial end-user with material swaps exposure (see above). A CSE is not required to collect IM from or post IM to commercial end-users.

There are two general methods for calculating initial margin, the standardized approach and the model-based approach. Under the standardized approach, the CSE must calculate IM collection amounts using a table/grid that is set out in the proposed rule.

The model-based approach calculates an amount of IM that is equal to the potential future exposure (''PFE'') of a swap or a netting set of swaps. PFE is an estimate of the one-tailed 99% confidence interval for an increase in the value of the swap over a 10 day period (*i.e.,* VaR model for a 10 day period). The model-based approach must meet the following requirements: (1) The model must have prior written approval by the Commission; (2) a CSE must demonstrate that the initial margin model continuously satisfies the rule's requirements; (3) a covered swap entity must notify the Commission in writing prior to making material changes to the model, such as: (a) Extending the use of the model to an additional product type; (b) making any change that results in material changes to the amount of IM; or (c) making any material changes to the assumptions of the model. The Commission may rescind its approval in whole or in part of an entity's margin model at any time.

The rules for variation margin are as follows: (1) On or before the business day after execution of an uncleared swap between a covered swap entity and a counterparty that is a swap entity or a financial end user, the covered swap entity must collect variation margin from or pay variation margin to the counterparty; (2) a CSE is not required to collect or pay variation from commercial end-users; and (3) a CSE is not required to collect, post, or pay margin unless and until the total amount of margin transfer to be collected or posted for an individual counterparty exceeds the minimum transfer amount.

The eligible collateral for variation margin is cash funds denominated in (a) USD, or (b) a currency in which payment under the swap contracts is required. The eligible collateral for initial margin includes (subject to haircuts on value) financial instruments in various categories, including cash, Treasury securities, and various publicly traded debt and equity instruments. A CSE may not collect or post as initial margin any asset that is a security issued by (i) the party providing such asset or an affiliate of that party; (ii) various banking entities as listed in the proposed rule; or (iii) certain government-sponsored enterprises unless an exception applies.

As defined in the rule, a financial end-user is any counterparty that is not a covered swap entity and includes, among others: (i) A commodity pool, commodity trading advisor and commodity pool operator (all defined in the CEA); (ii) a private fund (defined in Investment Advisers Act); (iii) an employee benefit plan, as defined in ERISA section 3; (iv) a person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature (defined in section 4(k) of the BHCA); (v) a person defined in (a)–(d), if that person organized under the laws of the U.S.; and (vi) any other entity that in the Commission's discretion is a financial end-user. A non-financial end-user is any entity that is not a financial end-user or an SD/MSP.

Generally, a CSE entering into a swap with a swap entity or a financial end-user with material swap exposure who posts initial margin to the counterparty must comply with the following conditions: (1) All funds posted as initial margin must be held by a third-party custodian (unaffiliated with either party in the swap); (2) the third-party custodian is prohibited from re-hypothecating (or otherwise transferring) the initial margin; (3) the third-party custodian is prohibited from reinvesting the initial margin in any asset that would not qualify as eligible collateral; and (4) the custodial agreement is legal, valid, binding and enforceable in the event of bankruptcy, insolvency, or similar proceedings.

Generally, a CSE entering into a swap with a swap entity or a financial end-user with a material swap exposure that collects initial margin from the counterparty must require the same conditions listed above for initial margin posted.

Generally, CSEs must comply with the minimum margin requirements for uncleared swaps on or before the following dates. For variation margin, covered swap entities must comply by December 1, 2015. Initial margin is subject to a phased-in period. The compliance date is December 1, 2015 when both (i) the CSE and its affiliates and (ii) its counterparty and its affiliates, have an average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange forwards and foreign exchange swaps for each business day in June, July and August 2015 that exceeds $4 trillion. The compliance date is December 1, 2016 when both (i) the CSE and its affiliates and (ii) its counterparty and its affiliates, have an average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange forwards and foreign exchange swaps for each business day in June, July and August 2016 that exceeds $3 trillion. The compliance date is December 1, 2017 when both (i) the CSE and its affiliates and (ii) its counterparty and its affiliates, have an average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange forwards and foreign exchange swaps for each business day in June, July and August 2017 that exceeds $2 trillion. The compliance date is December 1, 2018 when both (i) the CSE and its affiliates and (ii) its counterparty and its affiliates, have an average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange forwards and foreign exchange swaps for each business day in June, July and August 2018 that exceeds $1 trillion. The compliance date is December 1, 2019 for any other covered swap entity with respect to uncleared swaps and uncleared security-based swaps entered into with any other counterparty.

3. Status Quo Baseline

The baseline against which this proposed rule will be compared is the status quo. This requires the Commission to assess what is the current practice within the swaps industry. At present, swap market participants are not legally required to post either initial or variation margin

[129] For this rulemaking, a swap entity is either a swap dealer or a major swap participant.

when engaging in uncleared swaps. Nevertheless, for risk management purposes, many market participants currently undertake this practice.

In determining the current market practices, the Commission utilized several sources of swaps market data. These sources include (i) the ISDA Margin Survey 2014 (''ISDA Survey''), (ii) BIS's Quantitative impact study on margin requirements for non-centrally-cleared OTC derivatives (''BCBS/IOSCO Quantitative Impact Study''), and (iii) Swap Data Repository data (''SDR Data''). Although the data the Commission is considering might not be complete, the Commission requests comments regarding whether there is additional data that it should consider when developing its baseline.

a. ISDA Margin Survey

A resource containing current market practice for uncleared swaps is the ISDA Survey.[130] The use of collateral agreements (those with exposure and/or collateral balances) is substantial. The ISDA Survey estimates that roughly 90% of all global uncleared OTC derivatives trades have collateral agreements. 97% and 86% of global bilateral transactions involving credit and fixed income, respectively, are subject to collateral agreements or credit support annexes. The survey reports that the use of cash and government securities accounts for roughly 90% of uncleared global OTC derivative collateral, as has been the case in prior years. The total global collateral related to uncleared derivatives has decreased 14% from $3.7 trillion at the end of 2012 to $3.2 trillion at the end of 2013. The survey asserts that this decrease can be largely attributed to mandatory clearing requirements.

b. BCBS/IOSCO's Quantitative Impact Study

Another source containing current market practices for uncleared swaps is the BCBS/IOSCO Quantitative Impact Study.[131] According to the Study, BCBS/IOSCO Quantitative Impact Study respondents have roughly €319 trillion (approximately $415 trillion) in total outstanding notional derivative positions, are collecting a total of roughly €95 billion (approximately $124 billion) in initial margin and are posting roughly €6 billion (approximately $7.8 billion) in initial margin. Hence, average margin represents about 0.03% of the gross notional exposure.'' [132] The large difference between collected and posted margin reflects the fact that the BCBS/IOSCO Quantitative Impact Study respondents tend to be large derivative dealers with large swap portfolios with transactions that on aggregate mostly offset, have substantial capital, and who have high credit ratings, this generally leads to lower margins.

In light of the definition of potential future exposure in this proposal, it is useful to examine current practice. The table below, reproduced from the BCBS/IOSCO Quantitative Impact Study provides some statistics on potential future exposure, and related industry practices.

TABLE 4b—CURRENT MARGIN PRACTICES FOR UNCLEARED SWAPS

	Average	Median	Number of respondents
Margin period of risk (or risk horizon) in days	8.1	10.0	15
Confidence level (%) used	96.2%	96.3%	14
Length of the look-back period (in years) used in calibration of model	2.9	2.0	13
Level of initial margin as a percentage of potential future exposure	97.5%	100.0%	10
Margin frequency (in days) Variation margin	2.3	1.0	31
Initial margin	1.0	1.0	21

Respondents have provided information on initial margin frequency. Eight (8) of these respondents collect initial margin at deal inception. One (1) of them collects initial margin on an event-driven basis. The remaining 12 respondents collect initial margin daily.

The Commission seeks comment on the representativeness of the BCBS/IOSCO's Quantitative Impact Study. How do the calculations in the BCBS/IOSCO's Quantitative Impact Study compare to the experience of financial institutions? Commenters are encouraged to quantify when possible.

c. Estimates Using SDR Data

Finally, the Commission reports aggregated data derived from data submitted to swap data repositories in a weekly swaps market report.[133] Open swap positions in credit and interest rates as of June 27, 2014 for CFTC regulated CSEs (59 entities) are presented below. The table also includes total notional amount of swaps transacted by these entities in credit and interest rates during the period January to June 2014:

OPEN SWAPS AS OF JUNE 27, 2014

[Notional amount in US$ billions (double count)]

	Uncleared	Cleared
Interest Rates	253,434	223,744
Credit	10,039	879

[130] *See http://www2.isda.org/functional-areas/research/surveys/margin-surveys.*

[131] Bank for International Settlements, February 2013, page 31, *see http://www.bis.org/publ/bcbs242.pdf.*

[132] Bank for International Settlements, February 2013, page 31. *See http://www.bis.org/publ/bcbs242.pdf.*

[133] *See http://www.cftc.gov/MarketReports/SwapsReports/index.htm.*

AGGREGATE NOTIONAL SWAPS TRANSACTION (JANUARY TO JUNE 2014)

[Notional amount in US$ billions (double count)]

	Uncleared	Cleared
Interest Rates	12,630	39,816
Credit	1,362	5,717

The Commission notes that OCC's Economic Impact Analysis for Swaps Margin Proposed Rule [134] has estimated that in year one, OCC-supervised institutions will have to post total initial margin of approximately $331 billion with approximately $283 billion in interest rate and credit swaps. Using annualized notional swaps activity for just interest rate and credit, and adopting a similar methodology to the OCC's Economic Impact Analysis, the Commission estimates that the 59 CFTC regulated CSEs will have to post initial margin in year one of approximately $340 billion or possibly less as noted below. The OCC's estimate and the Commission's estimate are not based on the same data. The OCC's estimates are based on transactions activity implied by the open swaps positions from Call Report schedule RC–L. The Commission's estimates are based on transaction data reported to SDRs. To the extent SDR data includes financial end users without material swaps exposure, nonfinancial end users, sovereigns, and multilateral development banks who do not have to post collateral, the amount of required initial margin would be less than the Commission's estimate of approximately $340 billion. Further, the amount of required initial margin will be lower as a result of the $65 million threshold, too. While the OCC has made certain assumptions regarding coverage of the swaps activity by its regulated entities during the different compliance dates, the Commission does not have access to relevant data to make similar estimates. The Commission's initial margin estimates assume that uncleared swaps activities by CFTC regulated CSEs in these two asset classes will remain the same. These differences in approaches and the data sources means that the Commission's estimates will likely have overstated the actual margins that will be posted in year one after enactment.

The Commission points out that prudentially regulated CSEs, CFTC regulated CSEs, and SEC regulated CSEs will trade with each other. Thus, one cannot simply add the margin estimates by various regulators as this will double count the amount of initial margin collateral for swap transactions between differently regulated CSEs. The Commission seeks comment on how it should consider or allocate the common costs and benefits of the margin collateral that is required by more than one CSE regulator. Further, the Commission seeks comments on all aspects of its initial margin estimates and methods. Commenters are encouraged to quantify, if practical.

4. Section 15(a) Factors

a. Protection of Market Participants and the Public

Margin helps to protect market participants from counterparty credit risk. It also helps to protect the public by lowering the probability of a financial crisis, because margin helps to impede or contain the risk of a cascade of defaults occurring. A cascade occurs when one participant defaulting causes subsequent defaults by its counterparties, and so on, resulting in a domino effect and a potential financial crisis.

The derivatives positions of swap market participants are limited by their ability to post margin. If the ability to post margin is binding, then required margin may reduce swap market exposures for some participants. In many cases, reduced swap market exposure for a participant may lower their probability of default, all else equal. Further, when a swap participant defaults, the margin can be used to absorb the losses to the counterparty. This facilitates the non-defaulting party reestablishing a similar position with a new counterparty.

In requiring daily variation margin payments, the proposed rule would require counterparties to mark-to-market all open swap positions. The process of marking swap contracts to market or model, forces participants to recognize losses promptly and to adjust collateral accordingly. This helps to prevent the accumulation of large unrecognized losses and exposures. Consequently, this frequent settling up may reduce the probability of default of the party who has been experiencing losses on the contract. The proposed rule however, requires a minimum payment amount of $650,000, which provides counterparties with operational relief. This minimum payment does not lower the amount owed, but permits deferral of margin exchanges until it is operationally efficient. In providing this relief the Commission believes that it will lower the overall burden on the financial system, but as a result of this amount being relatively small the Commission believes this deferral would not noticeably increase the overall risk to the financial system and the general public.

The proposed rule also provides that initial margin must be held at a third-party custodian. The margin amount held there cannot be rehypothecated with both parties having access to the collateral. This access is designed to prevent a liquidity event, inducing a cascading event. With rehypothecation, the collateral of some parties may be linked or used as collateral posted for other positions—the same collateral is posted for many positions for many different entities, resulting in a rehypothecation chain. When a default or liquidity event occurs at one link along the rehypothecation chain, it might induce further defaults or liquidity events for other links in the rehypothecation chain, because access to the collateral for other positions may be obstructed by a default along the chain, which may result in a liquidity event along the entire chain.

The cost of providing initial margin collateral reflects the cost of obtaining the assets used as collateral, which is either the cost of raising external funds, or the foregone income that could been earned had the firm invested in a different asset (opportunity cost). The effective cost is the difference between the relevant cost of obtaining eligible assets and the return on the assets that can be pledged as collateral. The effective cost will likely differ between entities and even desks in the same entity as well as over time as conditions change. At one extreme, it may be that some entities providing initial margin, such as pension funds and asset managers, will provide assets as initial margin that they already own and would have owned even if no requirements were in place. In such cases the economic cost of providing initial margin collateral is anticipated to be low. In other cases, entities engaging

[134] *See http://www.regulations.gov/#!documentDetail;D=OCC-2011-0008-0131.*

in uncleared swaps will have to raise additional funds to secure assets that can be pledged as initial margin. The greater the costs of their funding, relative to the rates of return on the initial margin collateral, the greater the cost of providing collateral assets. It is difficult, however, to estimate these costs due to differences in funding costs across different types of entities as well as differences in funding costs over time, and differences in the rate of return on different collateral assets that may be used to satisfy the initial margin requirements. In addition, as a result of the fact that posting margin reduces the risk of default, the posting party could receive a benefit in the form of improved pricing of the swap or other beneficial changes to the relationship between the CSE and the counterparty. To the extent any such benefit is realized, it would offset a portion of the cost incurred in posting collateral.

The Commission seeks comment on the appropriate cost or a proxy for the costs to posting collateral for CFTC regulated entities, recognizing that CFTC entities may have different costs for pledging collateral. The Commission also seeks comments on the quantitative impact of these proposed rules on the pricing of swaps or other changes in the relationships between CSEs and counterparties.

The proposal also requires that variation margin be exchanged between covered swap entities and other swap entities and financial end-users. The Commission preliminarily believes that the impact of such requirements are low in the aggregate because: (i) regular exchange of variation margin is already a well-established market practice among a large number of market participants, and (ii) exchange of variation margin simply redistributes resources from one entity to another in a manner that imposes no aggregate liquidity costs. An entity that suffers a reduction in liquidity from posting variation margin is offset by an increase in the liquidity enjoyed by the entity receiving the variation margin because variation margin is posted with cash. The Commission notes that if the margin payments are not instantaneous, however, there may be a slight loss in liquidity while payments are being posted.

Posting margin may discourage some parties from hedging certain risks because it is no longer cost effective for them to do so. Consequently, this may reduce liquidity for some swap contracts. This concern is mitigated somewhat by exempting non-financial end users from having to post margin. Furthermore, not requiring parties to exchange variation margin when the change in valuation is small enough, $650,000, achieves additional cost savings. The proposed rule will create additional demand for eligible collateral to post as margin. Some advocates have expressed concern regarding the future availability of eligible assets for market participants to post as margin; [135] however, in developing this proposal, the Commission has added additional types of financial instruments to the list of eligible collateral in an attempt to mitigate this concern. That being said, it is too early to tell the extent to which eligible collateral will become more expensive to obtain. Even if higher demand for collateral does increase the price of certain existing assets, the Commission surmises that markets for various forms of collateral will clear. Higher prices may create incentives for creators of high quality assets to supply more in the future. For instance, sovereigns and credit worthy corporations may find it advantageous to issue more debt; as demand increases for their debt, prices will rise with corresponding borrowing rates decreasing. In addition, mutual funds and hedge funds may be willing for a fee to lend out assets that they hold in their portfolios to be pledged as initial margin. Some financial intermediaries may set up services to transform other financial instruments into eligible collateral, too.

According to the Committee on the Global Financial System, there seems to be sufficient eligible collateral at present and in the near term, as they noted that ''Current estimates suggest that the combined impact of liquidity regulation and OTC derivatives reforms could generate additional collateral demand to the tune of $4 trillion. At the same time, the supply of collateral assets is known to have risen significantly since end-2007. Outstanding amounts of AAA- and AA-rated government securities alone—based on the market capitalization of widely used benchmark indices—increased by $10.8 trillion between 2007 and 2012. Other measures suggest even greater increases in supply.'' [136] As discussed above, there may be a reduction in the number of swap contracts due to the cost of posting margin. Indeed, this may be the case even if the cost of posting eligible collateral does not increase in price. Finally, the proposed margin rules will be phased in gradually. This gives regulators the ability to make adjustments, if necessary.

b. The Efficiency, Competitiveness, and Integrity of Markets

The proposed margin requirements make cleared swaps relatively more attractive. The Commission is requiring ten day initial margins for uncleared swaps and only five day margin for cleared swaps. In addition, the Commission is only allowing limited netting for uncleared swaps. All else equal, due to multilateral netting, less collateral may be required in a cleared environment relative to an uncleared environment.[137]

The Commission is allowing only limited netting for uncleared swaps. Limited netting may encourage participants to use a small number of counterparties for multiple swap transactions, because participants can only net swaps from those made with the same counterparty. This may encourage the concentration of risk among a few counterparties. However, these concerns may be mitigated somewhat by performing frequent portfolio compression exercises that facilitate multilateral netting.

Another cost of the rules may be a reduction in the efficacy of hedging. Rules that make standardized swaps relatively less expensive may induce some entities to forego some customized swaps that may better match their exposures. However, before an entity decides to use a standardized swap over a customized uncleared swap, it must weigh the potentially lower margin costs from using standardized swaps against potentially losses from imperfect hedges. Consequently, market participants will still use customized swaps when they believe such swaps are superior for their hedging needs.

All the market protection benefits discussed above may help to improve the integrity of markets, because they make it more likely that swap market participants will be able to perform on their contractual obligations. This comes with potential losses to participants who have to place their capital into margin and, hence potentially receive lower anticipated returns on their capital.

[135] *See,* for instances, Singh (2010), ''Under-collateralisation and rehypothecation in the OTC derivatives markets,'' Banque de France Financial Stability Review (14); Sidanius and Zikes (2012), ''OTC derivatives reform and collateral demand impact,'' Financial Stability Paper (18); and Duffie, Scheicher, and Vuillemey (2014), ''Central Clearing and Collateral Demand,'' working paper, Stanford University.

[136] Committee on the Global Financial System, ''Asset encumbrance and the demand for collateral assets'', *CGFS Papers,* no. 49, May 2013, *http://www.bis.org/publ/cgfs49.pdf.*

[137] Anderson and Joeveer (2014), ''The Economics of Collateral,'' working paper, London School of Economics.

The Commission has endeavored to harmonize this rulemaking with the domestic prudential regulators, as well as with foreign regulators. Two of the goals of harmonization are to satisfy the statute as well as to create a more level playing field thereby promoting fairer competition between entities regulated in different jurisdictions or by different regulators. Otherwise, regulatory arbitrage opportunities might be substantial. Price arbitrage occurs when an identical asset simultaneously has two different prices, so that an arbitrager may buy that asset where it is cheaper and sell it where it is more expensive to garner a risk free profit. Similarly, a regulatory arbitrager takes advantage of regulatory discrepancies by adapting activities so as to locate them in jurisdictions to increase the arbitrager's regulatory profits (*i.e.,* regulatory benefits minus regulatory burdens).

The Commission is in discussion with domestic and foreign regulators on the material swap exposure threshold for financial end users to be required to post margin collateral. The Commission notes that some foreign regimes have proposed a higher threshold than $3 billion. In addition, the Commission realizes that setting a threshold lower than another jurisdiction may result in some market participants conducting some swaps in the jurisdiction with a lower threshold. The Commission is required, to the maximum extent practicable, to harmonize with prudential regulators, and domestic regulators are endeavoring to harmonize with foreign regulators, as well. Therefore, the Commission expects to consider the relative benefits that might come from having consistent standards against those that might come from having different thresholds. The Commission is seeking comment on the costs and benefits of setting the threshold for material swap exposure for financial end users to be required to post margin collateral at various levels. In particular, commenters are encouraged to discuss competitive impacts and to quantify, if practical. In addition, the Commission is seeking comments on the costs and benefits of not fully harmonizing its rules with those of the prudential regulators. Commenters are encouraged to discuss the operational difficulties and to quantify, if practical.

Inasmuch as larger banks tend to have a lower cost of capital than smaller banks, the posting of margin for uncleared swaps may result in a competitive advantage for larger banks when engaging in swaps, all else equal. Even though they are exempted from clearing as financial end users, small banks that have a material swaps exposure generally will have to post margin collateral when engaging in uncleared swaps with CFTC regulated CSEs. Thus, small banks may have to fund additional collateral to post as margin for uncleared swaps or engage in more cleared swaps that require relatively less collateral to post. The Commission is seeking comment on the costs and benefits of requiring small banks with material swaps exposures to post collateral with CFTC regulated CSEs. Commenters may choose to recognize that under the prudential regulators' proposal, small banks that have a material swaps exposure and that engage in swaps with prudentially regulated CSEs would have to post margin collateral for uncleared swaps, too. Further, commenters may also choose to recognize that the Commission is required to harmonize this rulemaking, to the maximum extent practicable, with the prudential regulators. Comments are encouraged to quantify, if practical.

c. Price Discovery

The Commission is requiring ten day initial margins for uncleared swaps and only five day margin for cleared swaps. In addition, the Commission is only allowing limited netting for uncleared swaps. Consequently, these rules promote the use of more standardized cleared swaps at the expense of more customized and opaque swaps.

To the extent traders increase the use of standardized cleared swaps in response to these rules, it may lead to greater transparency, overall, in the swaps markets. Compared to uncleared swaps, standardized swaps' prices tend to be more transparent and the price discovery process for such swaps may improve with higher volumes. Conversely, lower volumes for uncleared swaps may negatively impact the price discovery process for such swaps. However, the Commission believes that the potential reduction in the efficacy of the price discovery process for uncleared swaps is less of a concern, because the price-setting process for uncleared swaps is not conducted on a regulated platform or pursuant to rules requiring transparency and is therefore relatively opaque in the current environment, anyway.

The Commission recognizes that another way the rules may affect price discovery is by promoting confidence in the market. As such, the margin collateral rules may protect, prophylactically, the price discovery process of some swap contracts in some circumstances. The rules might protect price discovery by reducing the frequency of trading interruptions in segments of the swap market due to credit risk concerns. This rulemaking might improve price discovery in these instances, because the presence of collateral mitigates credit risk concerns, and thereby allows these swap contract markets to remain functioning. In turn, this permits market participants to continue to observe the prices of these swaps.

The Commission requests comment on potential effects of the rule on price discovery as well as on the relative use of cleared and uncleared swaps, and on whether particular types of market participants, including intermediaries such as regulated trading platforms, will be impacted differently by the rule. Commenters are urged to quantify the costs and benefits, if practicable.

d. Sound Risk Management Practices

Margin helps to mitigate the credit risk exposure resulting from swap contracts. Further, it is a sound practice to regularly mark to market or model to prevent the accumulation of unrecognized losses and exposures (through the exchange of variation margin). At the same time, requiring margin may help deter traders from taking advantage of the inherent leverage in certain swap transactions.

The Commission is requiring ten day initial margins for uncleared swaps and only five day initial margin for cleared swaps. Thus, the rule may result in the use of more standardized cleared swaps at the expense of more customized swaps which may be harder to evaluate and risk manage; however, this may result in market participants using non-optimal hedging techniques, as noted above, which may increase overall risk at a firm.

Prohibiting rehypothecation at third-party custodians when both parties have access to the collateral will be helpful in the time of default. Otherwise, a liquidity event might occur that induces a cascading event, in which the positions will be linked to other positions and counterparties. The policy of not allowing rehypothecation, however, requires that more collateral be available to post as margin. As discussed above, this does not seem to be a serious problem at present, but it might become one in the future. In addition, to protect parties against the circumstance when pledged collateral might be appropriated by the counterparty, margins must be held at third parties. Facilitating the use of more customized models might induce market participants to more thoroughly analyze the risks of their swap transactions, and may lead to better risk

management practices overall. The Commission is allowing various methods to model the amount of collateral required as initial margin for uncleared swap transactions, including Commission-approved standard models or more customized ones.

In this proposal, the Commission has added flexibility to what constitutes eligible collateral, allowing participants in uncleared swap transactions to 'optimize' their collateral inasmuch as they may reduce their opportunity cost losses from pledging assets with lower anticipated returns. This may result in market participants focusing on improving their margin and risk management practices.

e. Other Public Interest Considerations

The Commission has not identified any other public interest considerations.

List of Subjects

17 CFR Part 23

Swaps, Swap dealers, Major swap participants, Capital and margin requirements.

17 CFR Part 140

Authority delegations (Government agencies), Organization and functions (Government agencies).

For the reasons discussed in the preamble, the Commodity Futures Trading Commission proposes to amend 17 CFR chapter I as set forth below:

PART 23—SWAP DEALERS AND MAJOR SWAP PARTICIPANTS

■ 1. The authority citation for part 23 continues to read as follows:

Authority: 7 U.S.C. 1a, 2, 6, 6a, 6b, 6b–1, 6c, 6p, 6r, 6s, 6t, 9, 9a, 12, 12a, 13b, 13c, 16a, 18, 19, 21.

■ 2. Add subpart E to part 23 to read as follows:

Subpart E—Capital and Margin Requirements for Swap Dealers and Major Swap Participants

Sec.

23.100–23.149 [Reserved]
23.150 Scope.
23.151 Definitions applicable to margin requirements.
23.152 Collection and posting of initial margin.
23.153 Collection and payment of variation margin.
23.154 Calculation of initial margin.
23.155 Calculation of variation margin.
23.156 Forms of margin.
23.157 Custodial arrangements.
23.158 Margin documentation.
23.159 Compliance dates.
23.160–23.199 [Reserved]

§§ 23.100–23.149 [Reserved]

§ 23.150 Scope.

The margin requirements set forth in § 23.150 through § 23.159 shall apply to uncleared swaps, as defined in § 23.151, that are executed after the applicable compliance dates set forth in § 23.159.

§ 23.151 Definitions applicable to margin requirements.

For the purposes of §§ 23.150 through 23.159:

Affiliate means any company that controls, is controlled by, or is under common control with another company.

Bank holding company has the meaning specified in section 2 of the Bank Holding Company Act of 1956 (12 U.S.C. 1841).

Broker dealer means an entity registered with the Securities and Exchange Commission under section 15 of the Securities Exchange Act of 1934 (15 U.S.C. 78o).

Control of another company means:

(1) Ownership, control, or power to vote 25 percent or more of a class of voting securities of the company, directly or indirectly or acting through one or more other persons;

(2) Ownership or control of 25 percent or more of the total equity of the company, directly or indirectly or acting through one or more other persons; or

(3) Control in any manner of the election of a majority of the directors or trustees of the company.

Counterparty means the other party to a swap to which a covered swap entity is a party.

Covered counterparty means a financial end user with material swaps exposure, a swap dealer, or a major swap participant that enters into a swap with a covered swap entity.

Covered swap entity means a swap dealer or major swap participant for which there is no prudential regulator.

Cross-currency swap means a swap in which one party exchanges with another party principal and interest rate payments in one currency for principal and interest rate payments in another currency, and the exchange of principal occurs upon the inception of the swap, with reversal of the exchange of principal at a later date that is agreed upon at the inception of the swap.

Data source means an entity and/or method from which or by which a covered swap entity obtains prices for swaps or values for other inputs used in a margin calculation.

Depository institution has the meaning specified in section 3(c) of the Federal Deposit Insurance Act (12 U.S.C. 1813(c)).

Eligible collateral means collateral described in § 23.157.

Eligible master netting agreement means a written, legally enforceable agreement provided that:

(1) The agreement creates a single legal obligation for all individual transactions covered by the agreement upon an event of default, including upon an event of receivership, insolvency, liquidation, or similar proceeding, of the counterparty;

(2) The agreement provides the covered swap entity the right to accelerate, terminate, and close out on a net basis all transactions under the agreement and to liquidate or set off collateral promptly upon an event of default, including upon an event of receivership, insolvency, liquidation, or similar proceeding, of the counterparty, provided that, in any such case, any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions, other than in receivership, conservatorship, resolution under the Federal Deposit Insurance Act (12 U.S.C. 1811 *et seq.*), Title II of the Dodd-Frank Act (12 U.S.C. 4617) or under any similar insolvency law applicable to U.S. Government-sponsored enterprises (12 U.S.C. 2183 and 2279cc);

(3) The agreement does not contain a walkaway clause (that is, a provision that permits a non-defaulting counterparty to make a lower payment than it otherwise would make under the agreement, or no payment at all, to a defaulter or the estate of a defaulter, even if the defaulter or the estate of the defaulter is a net creditor under the agreement); and

(4) A covered swap entity that relies on the agreement for purposes of calculating the margin required by this part:

(i) Conducts sufficient legal review (and maintains sufficient written documentation of that legal review) to conclude with a well-founded basis that:

(A) The agreement meets the requirements of paragraphs (1) through (3) of this definition; and

(B) In the event of a legal challenge (including one resulting from default or from receivership, insolvency, liquidation, or similar proceeding) the relevant court and administrative authorities would find the agreement to be legal, valid, binding, and enforceable under the law of the relevant jurisdictions; and

(ii) Establishes and maintains written procedures to monitor possible changes in relevant law and to ensure that the agreement continues to satisfy the requirements of this definition.

Financial end user means

(1) A counterparty that is not a swap entity and that is:

(i) A bank holding company or an affiliate thereof; a savings and loan holding company; or a nonbank financial institution supervised by the Board of Governors of the Federal Reserve System under Title I of the Dodd-Frank Act (12 U.S.C. 5323);

(ii) A depository institution; a foreign bank; a Federal credit union or State credit union as defined in section 2 of the Federal Credit Union Act (12 U.S.C. 1752(1) and (6)); an institution that functions solely in a trust or fiduciary capacity as described in section 2(c)(2)(D) of the Bank Holding Company Act (12 U.S.C. 1841(c)(2)(D)); an industrial loan company, an industrial bank, or other similar institution described in section 2(c)(2)(H) of the Bank Holding Company Act (12 U.S.C. 1841(c)(2)(H));

(iii) An entity that is state-licensed or registered as:

(A) A credit or lending entity, including a finance company; money lender; installment lender; consumer lender or lending company; mortgage lender, broker, or bank; motor vehicle title pledge lender; payday or deferred deposit lender; premium finance company; commercial finance or lending company; or commercial mortgage company; except entities registered or licensed solely on account of financing the entity's direct sales of goods or services to customers;

(B) A money services business, including a check casher; money transmitter; currency dealer or exchange; or money order or traveler's check issuer;

(iv) A regulated entity as defined in section 1303(20) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 U.S.C. 4502(20)) and any entity for which the Federal Housing Finance Agency or its successor is the primary federal regulator;

(v) Any institution chartered and regulated by the Farm Credit Administration in accordance with the Farm Credit Act of 1971, as amended, 12 U.S.C. 2001 *et seq.;*

(vi) A securities holding company; a broker or dealer; an investment adviser as defined in section 202(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80b–2(a)); an investment company registered with the Securities and Exchange Commission under the Investment Company Act of 1940 (15 U.S.C. 80a–1 *et seq.*).

(vii) A private fund as defined in section 202(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80–b–2(a)); an entity that would be an investment company under section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a–3) but for section 3(c)(5)(C); or an entity that is deemed not to be an investment company under section 3 of the Investment Company Act of 1940 pursuant to Investment Company Act Rule 3a–7 of the Securities and Exchange Commission (17 CFR 270.3a–7);

(viii) A commodity pool, a commodity pool operator, a commodity trading advisor, or a futures commission merchant;

(ix) An employee benefit plan as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income and Security Act of 1974 (29 U.S.C. 1002);

(x) An entity that is organized as an insurance company, primarily engaged in writing insurance or reinsuring risks underwritten by insurance companies, or is subject to supervision as such by a State insurance regulator or foreign insurance regulator;

(xi) An entity that is, or holds itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in loans, securities, swaps, funds or other assets for resale or other disposition or otherwise trading in loans, securities, swaps, funds or other assets;

(xii) A person that would be a financial entity described in paragraphs (1)(i)–(xi) of this definition if it were organized under the laws of the United States or any State thereof; or

(xiii) Notwithstanding paragraph (2) of this definition, any other entity that the Commission determines should be treated as a financial end user.

(2) The term ''financial end user'' does not include any counterparty that is:

(i) A sovereign entity;

(ii) A multilateral development bank;

(iii) The Bank for International Settlements;

(iv) An entity that is exempt from the definition of financial entity pursuant to section 2(h)(7)(C)(iii) of the Act and implementing regulations; or

(v) An affiliate that qualifies for the exemption from clearing pursuant to section 2(h)(7)(D) of the Act.

Foreign bank has the meaning specified in section 1 of the International Banking Act of 1978 (12 U.S.C. 3101).

Foreign exchange forward and foreign exchange swap mean any foreign exchange forward, as that term is defined in section 1a(24) of the Act, and foreign exchange swap, as that term is defined in section 1a(25) of the Act.

Initial margin means collateral collected or posted to secure potential future exposure under one or more uncleared swaps.

Initial margin threshold amount means an aggregate credit exposure of $65 million resulting from all uncleared swaps and uncleared security-based swaps between a covered swap entity and its affiliates, and a covered counterparty and its affiliates.

Major currencies means

(1) United States Dollar (USD);

(2) Canadian Dollar (CAD);

(3) Euro (EUR);

(4) United Kingdom Pound (GBP);

(5) Japanese Yen (JPY);

(6) Swiss Franc (CHF);

(7) New Zealand Dollar (NZD);

(8) Australian Dollar (AUD);

(9) Swedish Kronor (SEK);

(10) Danish Kroner (DKK);

(11) Norwegian Krone (NOK); and

(12) Any other currency designated by the Commission.

Market intermediary means

(1) A securities holding company;

(2) A broker or dealer;

(3) A futures commission merchant;

(4) A swap dealer; or

(5) A security-based swap dealer.

Material swaps exposure for an entity means that the entity and its 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 $3 billion, where such amount is calculated only for business days.

Minimum transfer amount means an initial margin or variation margin amount under which no actual transfer of funds is required. The minimum transfer amount shall be $650,000 or such other amount as the Commission may establish by order.

Multilateral development bank means

(1) The International Bank for Reconstruction and Development;

(2) The Multilateral Investment Guarantee Agency;

(3) The International Finance Corporation;

(4) The Inter-American Development Bank;

(5) The Asian Development Bank;

(6) The African Development Bank;

(7) The European Bank for Reconstruction and Development;

(8) The European Investment Bank;

(9) The European Investment Fund;

(10) The Nordic Investment Bank;

(11) The Caribbean Development Bank;

(12) The Islamic Development Bank;

(13) The Council of Europe Development Bank; and

(14) Any other entity that provides financing for national or regional

development in which the U.S. government is a shareholder or contributing member or which the Commission determines poses comparable credit risk.

Non-financial end user means a counterparty that is not a swap dealer, a major swap participant, or a financial end user.

Prudential regulator has the meaning specified in section 1a(39) of the Act.

Savings and loan holding company has the meaning specified in section 10(n) of the Home Owners' Loan Act (12 U.S.C. 1467a(n)).

Securities holding company has the meaning specified in section 618 of the Dodd-Frank Act (12 U.S.C. 1850a).

Security-based swap has the meaning specified in section 3(a)(68) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(68)).

Sovereign entity means a central government (including the U.S. government) or an agency, department, ministry, or central bank of a central government.

State means any State, commonwealth, territory, or possession of the United States, the District of Columbia, the Commonwealth of Puerto Rico, the Commonwealth of the Northern Mariana Islands, American Samoa, Guam, or the United States Virgin Islands.

Subsidiary means a company that is controlled by another company.

Swap entity means a swap dealer or major swap participant.

Uncleared security-based swap means a security-based swap that is not cleared by a clearing agency registered with the Securities and Exchange Commission.

Uncleared swap means a swap that is not cleared by a registered derivatives clearing organization, or by a clearing organization that has received a no-action letter or other exemptive relief from the Commission permitting it to clear certain swaps for U.S. persons without being registered as a derivatives clearing organization.

U.S. Government-sponsored enterprise means an entity established or chartered by the U.S. government to serve public purposes specified by federal statute but whose debt obligations are not explicitly guaranteed by the full faith and credit of the U.S. government.

Variation margin means a payment by a party to its counterparty to meet an obligation under one or more swaps between the parties as a result of a change in value of such obligations since the trade was executed or the previous time such payment was made.

§ 23.152 Collection and posting of initial margin.

(a) *Collection*—(1) *Initial obligation.* On or before the business day after execution of an uncleared swap between a covered swap entity and a covered counterparty, the covered swap entity shall collect initial margin from the covered counterparty in an amount equal to or greater than an amount calculated pursuant to § 23.154, in a form that complies with § 23.156, and pursuant to custodial arrangements that comply with § 23.157.

(2) *Continuing obligation.* The covered swap entity shall continue to hold initial margin from the covered counterparty in an amount equal to or greater than an amount calculated each business day pursuant to § 23.154, in a form that complies with § 23.156, and pursuant to custodial arrangements that comply with § 23.157, until such uncleared swap is terminated or expires.

(b) *Posting*—(1) *Initial obligation.* On or before the business day after execution of an uncleared swap between a covered swap entity and a covered counterparty that is a financial end user, the covered swap entity shall post initial margin with the covered counterparty in an amount equal to or greater than an amount calculated pursuant to § 23.154, in a form that complies with § 23.156, and pursuant to custodial arrangements that comply with § 23.157.

(2) *Continuing obligation.* The covered swap entity shall continue to post initial margin with the covered counterparty in an amount equal to or greater than an amount calculated each business day pursuant to § 23.154, in a form that complies with § 23.156, and pursuant to custodial arrangements that comply with § 23.157, until such uncleared swap is terminated or expires.

(c) *Satisfaction of collection and posting requirements.* A covered swap entity shall not be deemed to have violated its obligation to collect or to post initial margin from a covered counterparty if:

(1) The covered counterparty has refused or otherwise failed to provide, or to accept, the required initial margin to, or from, the covered swap entity; and

(2) The covered swap entity has:

(i) Made the necessary efforts to collect or to post the required initial margin, including the timely initiation and continued pursuit of formal dispute resolution mechanisms, including pursuant to § 23.504(b)(4), if applicable, or has otherwise demonstrated upon request to the satisfaction of the Commission that it has made appropriate efforts to collect or to post the required initial margin; or

(ii) Commenced termination of the uncleared swap with the covered counterparty promptly following the applicable cure period and notification requirements.

§ 23.153 Collection and payment of variation margin.

(a) *Initial obligation.* On or before the business day after execution of an uncleared swap between a covered swap entity and a counterparty that is a swap entity or a financial end user, the covered swap entity shall collect variation margin from, or pay variation margin to, the counterparty as calculated pursuant to § 23.155 and in a form that complies with § 23.156.

(b) *Continuing obligation.* The covered swap entity shall continue to collect variation margin from, or to pay variation margin to, the counterparty as calculated each business day pursuant to § 23.155 and in a form that complies with § 23.156 each business day until such uncleared swap is terminated or expires.

(c) *Netting.* To the extent that more than one uncleared swap is executed pursuant to an eligible master netting agreement between a covered swap entity and a counterparty, a covered swap entity may calculate and comply with the variation margin requirements of this section on an aggregate basis with respect to all uncleared swaps governed by such agreement. If the agreement covers uncleared swaps entered into before the applicable compliance date set forth in § 23.159, those swaps must be included in the aggregate for the purposes of calculation and complying with the variation margin requirements of this section.

(d) *Satisfaction of collection and payment requirements.* A covered swap entity shall not be deemed to have violated its obligation to collect or to pay variation margin from a counterparty if:

(1) The counterparty has refused or otherwise failed to provide or to accept the required variation margin to or from the covered swap entity; and

(2) The covered swap entity has:

(i) Made the necessary efforts to collect or to pay the required variation margin, including the timely initiation and continued pursuit of formal dispute resolution mechanisms, or has otherwise demonstrated upon request to the satisfaction of the Commission that it has made appropriate efforts to collect or to pay the required variation margin; or

(ii) Commenced termination of the uncleared swap with the counterparty promptly following the applicable cure period and notification requirements.

§ 23.154 Calculation of initial margin.

(a) *Means of calculation.* (1) Each business day each covered swap entity shall calculate an initial margin amount to be collected from each covered counterparty using:

(i) A risk-based model that meets the requirements of paragraph (b) of this section; or

(ii) The table-based method set forth in paragraph (c) of this section.

(2) Each business day each covered swap entity shall calculate an initial margin amount to be posted with each covered counterparty that is a financial end user using:

(i) A risk-based model that meets the requirements of paragraph (b) of this section; or

(ii) The table-based method set forth in paragraph (c) of this section.

(3) Each covered swap entity may reduce the amounts calculated pursuant to paragraphs (a)(1) and (2) of this section by the initial margin threshold amount provided that the reduction does not include any portion of the initial margin threshold amount already applied by the covered swap entity or its affiliates in connection with other uncleared swaps or uncleared security-based swaps with the counterparty or its affiliates.

(4) The amounts calculated pursuant to paragraph (a)(3) of this section shall not be less than zero.

(5) A covered swap entity shall not be required to collect or to post an amount below the minimum transfer amount.

(6) For risk management purposes, each business day each covered swap entity shall calculate a hypothetical initial margin requirement for each swap for which the counterparty is a non-financial end user that has material swaps exposure to the covered swap entity as if the counterparty were a covered counterparty and compare that amount to any initial margin required pursuant to the margin documentation.

(b) *Risk-based Models*—(1) *Commission approval.* (i) A covered swap entity shall obtain the written approval of the Commission to use a model to calculate the initial margin required in this part.

(ii) A covered swap entity shall demonstrate that the model satisfies all of the requirements of this section on an ongoing basis.

(iii) A covered swap entity shall notify the Commission in writing 60 days prior to:

(A) Extending the use of an initial margin model that has been approved to an additional product type;

(B) Making any change to any initial margin model that has been approved that would result in a material change in the covered swap entity's assessment of initial margin requirements; or

(C) Making any material change to modeling assumptions used by the initial margin model.

(iv) The Commission may rescind its approval of the use of any initial margin model, in whole or in part, or may impose additional conditions or requirements if the Commission determines, in its sole discretion, that the model no longer complies with this section.

(2) *Applicability to multiple swaps.* To the extent that more than one uncleared swap is executed pursuant to an eligible master netting agreement between a covered swap entity and a covered counterparty, a covered swap entity may use its initial margin model to calculate and comply with the initial margin requirements on an aggregate basis with respect to all uncleared swaps governed by such agreement. If the agreement covers uncleared swaps entered into before the applicable compliance date, those swaps must be included in the aggregate in the initial margin model for the purposes of calculating and complying with the initial margin requirements.

(3) *Elements of the model.* (i) The model shall calculate an amount of initial margin that is equal to the potential future exposure of the uncleared swap or netting set of uncleared swaps covered by an eligible master netting agreement. Potential future exposure is an estimate of the one-tailed 99 percent confidence interval for an increase in the value of the uncleared swap or netting set of uncleared swaps due to an instantaneous price shock that is equivalent to a movement in all material underlying risk factors, including prices, rates, and spreads, over a holding period equal to the shorter of ten business days or the maturity of the swap.

(ii) All data used to calibrate the model shall be based on an equally weighted historical observation period of at least one year and not more than five years and must incorporate a period of significant financial stress for each broad asset class that is appropriate to the uncleared swaps to which the initial margin model is applied.

(iii) The model shall use risk factors sufficient to measure all material price risks inherent in the transactions for which initial margin is being calculated. The risk categories shall include, but should not be limited to, foreign exchange or interest rate risk, credit risk, equity risk, agricultural commodity risk, energy commodity risk, metal commodity risk, and other commodity risk, as appropriate. For material exposures in significant currencies and markets, modeling techniques shall capture spread and basis risk and shall incorporate a sufficient number of segments of the yield curve to capture differences in volatility and imperfect correlation of rates along the yield curve.

(iv) In the case of an uncleared cross-currency swap, the model need not recognize any risks or risk factors associated with the fixed, physically-settled foreign exchange transactions associated with the exchange of principal embedded in the cross-currency swap. The model shall recognize all material risks and risk factors associated with all other payments and cash flows that occur during the life of the uncleared cross-currency swap.

(v) The model may calculate initial margin for an uncleared swap or netting set of uncleared swaps covered by an eligible master netting agreement. It may reflect offsetting exposures, diversification, and other hedging benefits for uncleared swaps that are governed by the same eligible master netting agreement by incorporating empirical correlations within the following broad risk categories, provided the covered swap entity validates and demonstrates the reasonableness of its process for modeling and measuring hedging benefits: agriculture, credit, energy, equity, foreign exchange/interest rate, metals, and other. Empirical correlations under an eligible master netting agreement may be recognized by the model within each broad risk category, but not across broad risk categories.

(vi) If the model does not explicitly reflect offsetting exposures, diversification, and hedging benefits between subsets of uncleared swaps within a broad risk category, the covered swap entity shall calculate an amount of initial margin separately for each subset of uncleared swaps for which offsetting exposures, diversification, and other hedging benefits are explicitly recognized by the model. The sum of the initial margin amounts calculated for each subset of uncleared swaps within a broad risk category shall be used to determine the aggregate initial margin due from the counterparty for the portfolio of uncleared swaps within the broad risk category.

(vii) The sum of the initial margins calculated for each broad risk category shall be used to determine the aggregate initial margin due from the counterparty.

(viii) The model shall not permit the calculation of any initial margin amount to be offset by, or otherwise take into account, any initial margin that may be owed or otherwise payable by the covered swap entity to the counterparty.

(ix) The model shall include all material risks arising from the nonlinear price characteristics of option positions or positions with embedded optionality and the sensitivity of the market value of the positions to changes in the volatility of the underlying rates, prices, or other material risk factors.

(x) The covered swap entity shall not omit any risk factor from the calculation of its initial margin that the covered swap entity uses in its model unless it has first demonstrated to the satisfaction of the Commission that such omission is appropriate.

(xi) The covered swap entity shall not incorporate any proxy or approximation used to capture the risks of the covered swap entity's actual swaps unless it has first demonstrated to the satisfaction of the Commission that such proxy or approximation is appropriate.

(xii) The covered swap entity shall have a rigorous and well-defined process for re-estimating, re-evaluating, and updating its internal models to ensure continued applicability and relevance.

(xiii) The covered swap entity shall review and, as necessary, revise the data used to calibrate the model at least monthly, and more frequently as market conditions warrant, ensuring that the data incorporate a period of significant financial stress appropriate to the uncleared swaps to which the model is applied.

(xiv) The level of sophistication of the initial margin model shall be commensurate with the complexity of the swaps to which it is applied. In calculating an initial margin amount, the model may make use of any of the generally accepted approaches for modeling the risk of a single instrument or portfolio of instruments.

(xv) The Commission may in its sole discretion require a covered swap entity using a model to collect a greater amount of initial margin than that determined by the covered swap entity's model if the Commission determines that the additional collateral is appropriate due to the nature, structure, or characteristics of the covered swap entity's transactions or is commensurate with the risks associated with the transaction.

(4) *Periodic review.* A covered swap entity shall periodically, but no less frequently than annually, review its model in light of developments in financial markets and modeling technologies, and enhance the model as appropriate to ensure that it continues to meet the requirements for approval in this section.

(5) *Control, oversight, and validation mechanisms.* (i) The covered swap entity shall maintain a risk management unit in accordance with § 23.600(c)(4)(i) that is independent from the business trading unit (as defined in § 23.600).

(ii) The covered swap entity's risk control unit shall validate its model prior to implementation and on an ongoing basis. The covered swap entity's validation process shall be independent of the development, implementation, and operation of the model, or the validation process shall be subject to an independent review of its adequacy and effectiveness. The validation process shall include:

(A) An evaluation of the conceptual soundness of (including developmental evidence supporting) the model;

(B) An ongoing monitoring process that includes verification of processes and benchmarking by comparing the covered swap entity's model outputs (estimation of initial margin) with relevant alternative internal and external data sources or estimation techniques including benchmarking against observable margin standards to ensure that the initial margin is not less than what a derivatives clearing organization would require for similar cleared transactions; and

(C) An outcomes analysis process that includes back testing the model.

(iii) If the validation process reveals any material problems with the model, the covered swap entity shall notify the Commission of the problems, describe to the Commission any remedial actions being taken, and adjust the model to insure an appropriately conservative amount of required initial margin is being calculated.

(iv) In accordance with § 23.600(e)(2), the covered swap entity shall have an internal audit function independent of the business trading unit and the risk management unit that at least annually assesses the effectiveness of the controls supporting the model measurement systems, including the activities of the business trading units and risk control unit, compliance with policies and procedures, and calculation of the covered swap entity's initial margin requirements under this part. At least annually, the internal audit function shall report its findings to the covered swap entity's governing body, senior management, and chief compliance officer.

(6) *Documentation.* The covered swap entity shall adequately document all material aspects of its model, including management and valuation of uncleared swaps to which it applies, the control, oversight, and validation of the model, any review processes and the results of such processes.

(7) *Escalation procedures.* The covered swap entity must adequately document authorization procedures, including escalation procedures that require review and approval of any change to the initial margin calculation under the model, demonstrable analysis that any basis for any such change is consistent with the requirements of this section, and independent review of such demonstrable analysis and approval.

(c) *Table-based method.* If a model meeting the standards set forth in paragraph (b) of this section is not used, initial margin shall be calculated in accordance with this paragraph.

(1) *Standardized initial margin schedule.*

Asset class	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/Currency	6
Cross Currency Swaps: 0–2 year duration	1
Cross Currency Swaps: 2–5 year duration	2
Cross currency Swaps: 5+ year duration	4
Interest Rate: 0–2 year duration	1
Interest Rate: 2–5 year duration	2
Interest Rate: 5+ year duration	4
Other	15

(2) *Net to gross ratio adjustment.* (i) For multiple uncleared swaps subject to an eligible master netting agreement, the initial margin amount under the standardized table shall be computed according to this paragraph.

(ii) Initial Margin = 0.4 × Gross Initial Margin + 0.6 × Net-to-Gross Ratio × Gross Initial Margin, where

(A) Gross Initial Margin = the sum of the product of each uncleared swap's effective notional amount and the gross initial margin requirement for all uncleared swaps subject to the eligible master netting agreement;

(B) Net-to-Gross Ratio = the ratio of the net current replacement cost to the gross current replacement cost;

(C) Gross Current Replacement cost = the sum of the replacement cost for each uncleared swap subject to the eligible master netting agreement for which the cost is positive; and

(D) Net Current Replacement Cost = the total replacement cost for all uncleared swaps subject to the eligible master netting agreement.

§ 23.155 Calculation of variation margin.

(a) *Means of calculation.* (1) Each business day each covered swap entity shall calculate variation margin for itself and for each counterparty that is a swap entity or a financial end user using a methodology and inputs that to the maximum extent practicable rely on recently-executed transactions, valuations provided by independent third parties, or other objective criteria.

(2) Each covered swap entity shall have in place alternative methods for determining the value of an uncleared swap in the event of the unavailability or other failure of any input required to value a swap.

(3) For risk management purposes, each business day each covered swap entity shall calculate a hypothetical variation margin requirement for each swap for which the counterparty is a non-financial end user that has material swaps exposure to the covered counterparty as if the counterparty were a covered swap entity and compare that amount to any variation margin required pursuant to the margin documentation.

(b) *Control mechanisms.* (1) Each covered swap entity shall create and maintain documentation setting forth the variation methodology with sufficient specificity to allow the counterparty, the Commission, and any applicable prudential regulator to calculate a reasonable approximation of the margin requirement independently.

(2) Each covered swap entity shall evaluate the reliability of its data sources at least annually, and make adjustments, as appropriate.

(3) The Commission at any time may require a covered swap entity to provide further data or analysis concerning the methodology or a data source, including:

(i) An explanation of the manner in which the methodology meets the requirements of this section;

(ii) A description of the mechanics of the methodology;

(iii) The theoretical basis of the methodology;

(iv) The empirical support for the methodology; and

(v) The empirical support for the assessment of the data sources.

§ 23.156 Forms of margin.

(a) *Initial margin*—(1) *Eligible collateral.* A covered swap entity shall collect and post as initial margin for trades with a covered counterparty only the following assets:

(i) U.S. dollars;

(ii) A major currency;

(iii) A currency in which payment obligations under the swap are required to be settled;

(iv) 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;

(v) 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;

(vi) 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 government-sponsored enterprise's eligible securities; or

(vii) A security that is issued by, or fully guaranteed as to the payment of principal and interest by, the European Central Bank or a sovereign entity that is assigned no higher than a 20 percent risk weight under the capital rules applicable to swap dealers subject to regulation by a prudential regulator;

(viii) 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;

(ix) Other publicly-traded debt that has been deemed acceptable as initial margin by a prudential regulator; or

(x) A publicly traded common equity security that is included in:

(A) The Standard & Poor's Composite 1500 Index or any other similar index of liquid and readily marketable equity securities as determined by the Commission; or

(B) An index that a covered swap entity's supervisor in a foreign jurisdiction recognizes for purposes of including publicly traded common equity as initial margin under applicable regulatory policy, if held in that foreign jurisdiction; or

(xi) Gold.

(2) *Prohibition of certain assets.* A covered swap entity may not collect or post as initial margin any asset that is a security issued by:

(i) The party providing such asset or an affiliate of that party,

(ii) A bank holding company, a savings and loan holding company, 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 an affiliate of any of the foregoing institutions, or

(iii) A U.S. government-sponsored enterprise after the termination of capital support or another form of direct financial assistance received from the U.S. government that enables the repayments of the government-sponsored enterprise's eligible securities unless:

(A) The security meets the requirements of paragraph (a)(1)(iv) of this section;

(B) The security meets the requirements of paragraph (a)(1)(vii) of this section; or

(C) The security meets the requirements of paragraph (a)(1)(viii) of this section.

(3) *Haircuts.* (i) Each covered swap entity shall apply haircuts to any asset posted or received as initial margin under this section that reflect the credit and liquidity characteristics of the asset.

(ii) At a minimum, each covered swap entity shall apply haircuts to any asset posted or received as initial margin under this section in accordance with the following table:

STANDARDIZED HAIRCUT SCHEDULE

Cash in same currency as swap obligation	0.0
Eligible government and related debt (e.g., central bank, multilateral development bank, GSE securities identified in paragraph (a)(1)(iv) of this section): 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

STANDARDIZED HAIRCUT SCHEDULE—Continued

Equities included in S&P 1500 Composite or related index but not S&P 500 or related index	25.0
Gold	15.0
Additional (additive) haircut on asset in which the currency of the swap obligation differs from that of the collateral asset	8.0

(iii) The value of initial margin collateral that is calculated according to the schedule in paragraph (a)(3)(ii) of this section will be computed as follows: The value of initial margin collateral for any collateral asset class will be computed as the product of the total value of collateral in any asset class and one minus the applicable haircut expressed in percentage terms. The total value of all initial margin collateral is calculated as the sum of the value of each type of collateral asset.

(4) *Monitoring Obligation.* A covered swap entity shall monitor the market value and eligibility of all collateral collected and held to satisfy initial margin required by this part. To the extent that the market value of such collateral has declined, the covered swap entity shall promptly collect such additional eligible collateral as is necessary to bring itself into compliance with the margin requirements of this part. To the extent that the collateral is no longer eligible, the covered swap entity shall promptly obtain sufficient eligible replacement collateral to comply with this part.

(5) *Excess initial margin.* A covered swap entity may collect initial margin that is not required pursuant to this part in any form of collateral.

(b) *Variation margin*—(1) *Eligible assets.* A covered swap entity shall pay and collect as variation margin to or from a covered counterparty only cash in the form of:

(i) U.S. dollars; or

(ii) A currency in which payment obligations under the swap are required to be settled.

(2) *Collection obligation.* A covered swap entity shall not be deemed to have violated its obligation under this paragraph to collect variation margin if:

(i) The counterparty has refused or otherwise failed to provide the variation margin to the covered swap entity; and

(ii) The covered swap entity:

(A) Has made the necessary efforts to collect the variation margin, including the timely initiation and continued pursuit of formal dispute resolution mechanisms, including § 23.504(b), if applicable, or has otherwise demonstrated upon request to the satisfaction of the Commission that it has made appropriate efforts to collect the variation margin; or

(B) Has commenced termination of the swap or security-based swap with the counterparty.

§ 23.157 Custodial arrangements.

(a) *Initial margin posted by covered swap entities.* Each covered swap entity that posts initial margin with respect to an uncleared swap shall require that all funds or other property that the covered swap entity provides as initial margin be held by one or more custodians that are not affiliates of the covered swap entity or the counterparty.

(b) *Initial margin collected by covered swap entities.* Each covered swap entity that collects initial margin required by § 23.152 with respect to an uncleared swap shall require that such initial margin be held at one or more custodians that are not affiliates of the covered swap entity or the counterparty.

(c) *Custodial agreement.* Each covered swap entity shall enter into an agreement with each custodian that holds funds pursuant to paragraphs (a) or (b) of this section that:

(1) Prohibits the custodian from rehypothecating, repledging, reusing, or otherwise transferring (through securities lending, repurchase agreement, reverse repurchase agreement or other means) the funds or other property held by the custodian;

(2) Notwithstanding paragraph (c)(1) of this section, with respect to collateral posted or collected pursuant to § 23.152, requires the posting party, when it substitutes or directs the reinvestment of posted collateral held by the custodian:

(i) To substitute only funds or other property that are in a form that meets the requirements of § 23.156 and in an amount that meets the requirements of § 23.152, subject to applicable haircuts; and

(ii) To reinvest funds only in assets that are in a form that meets the requirements of § 23.156 and in an amount that meets the requirements of § 23.152, subject to applicable haircuts;

(3) Is legal, valid, binding, and enforceable under the laws of all relevant jurisdictions including in the event of bankruptcy, insolvency, or a similar proceeding.

§ 23.158 Margin documentation.

(a) *General requirement.* Each covered swap entity shall execute documentation with each counterparty that complies with the requirements of § 23.504 and that complies with this section. For uncleared swaps between a covered swap entity and a covered counterparty, the documentation shall provide the covered swap entity with the contractual right and obligation to exchange initial margin and variation margin in such amounts, in such form, and under such circumstances as are required by §§ 23.150 through 23.159. For uncleared swaps between a covered swap entity and a non-financial entity, the documentation shall specify whether initial and/or variation margin will be exchanged and, if so, the documentation shall comply with paragraph (b) of this section.

(b) *Contents of the documentation.* The margin documentation shall specify the following:

(1) The methodology and data sources to be used to value uncleared swaps and collateral and to calculate initial margin for uncleared swaps entered into between the covered swap entity and the counterparty;

(2) The methodology and data sources to be used to value positions and to calculate variation margin for uncleared swaps entered into between the covered swap entity participant and the counterparty;

(3) The procedures by which any disputes concerning the valuation of uncleared swaps, or the valuation of assets posted as initial margin or paid as variation margin may be resolved;

(4) Any thresholds below which initial margin need not be posted by the covered swap entity and/or the counterparty; and

(5) Any thresholds below which variation margin need not be paid by the covered swap entity and/or the counterparty.

§ 23.159 Compliance dates.

(a) Covered swap entities must comply with the minimum margin requirements for uncleared swaps on or before the following dates for uncleared swaps entered into on or after the following dates:

(1) December 1, 2015 for the requirements in § 23.153 for variation margin.

(2) December 1, 2015 for the requirements in § 23.152 for initial margin for any uncleared swaps where both the covered swap entity combined with all its affiliates and its counterparty combined with all its affiliates, have an average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange forwards, and foreign exchange swaps in June, July, and August 2015 that exceeds $4 trillion, where such amounts are calculated only for business days.

(3) December 1, 2016 for the requirements in § 23.152 for initial margin for any uncleared swaps where

both the covered swap entity combined with all its affiliates and its counterparty combined with all its affiliates, have an average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange forwards, and foreign exchange swaps in June, July and August 2016 that exceeds $3 trillion, where such amounts are calculated only for business days.

(4) December 1, 2017 for the requirements in § 23.152 for initial margin for any uncleared swaps where both the covered swap entity combined with all its affiliates and its counterparty combined with all its affiliates have an average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange forwards, and foreign exchange swaps in June, July and August 2017 that exceeds $2 trillion, where such amounts are calculated only for business days.

(5) December 1, 2018 for the requirements in § 23.152 for initial margin for any uncleared swaps where both the covered swap entity combined with all its affiliates and its counterparty combined with all its affiliates have an average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange forwards, and foreign exchange swaps in June, July and August 2018 that exceeds $1 trillion, where such amounts are calculated only for business days.

(6) December 1, 2019 for the requirements in § 23.152 for initial margin for any other covered swap entity with respect to uncleared swaps entered into with any other counterparty.

(b) Once a covered swap entity and its counterparty must comply with the margin requirements for uncleared swaps based on the compliance dates in paragraph (a) of this section, the covered swap entity and its counterparty shall remain subject to the requirements of this subpart.

§§ 23.160–23.199 [Reserved]

■ 3. In § 23.701 revise paragraphs (a)(1), (d), and (f) to read as follows:

§ 23.701 Notification of right to segregation.

(a) * * *

(1) Notify each counterparty to such transaction that the counterparty has the right to require that any Initial Margin the counterparty provides in connection with such transaction be segregated in accordance with §§ 23.702 and 23.703 except in those circumstances where segregation is mandatory pursuant to § 23.157;

* * * * *

(d) Prior to confirming the terms of any such swap, the swap dealer or major swap participant shall obtain from the counterparty confirmation of receipt by the person specified in paragraph (c) of this section of the notification specified in paragraph (a) of this section, and an election, if applicable, to require such segregation or not. The swap dealer or major swap participant shall maintain such confirmation and such election as business records pursuant to § 1.31 of this chapter.

* * * * *

(f) A counterparty's election, if applicable, to require segregation of Initial Margin or not to require such segregation, may be changed at the discretion of the counterparty upon written notice delivered to the swap dealer or major swap participant, which changed election shall be applicable to all swaps entered into between the parties after such delivery.

PART 140—ORGANIZATION, FUNCTIONS, AND PROCEDURES OF THE COMMISSION

■ 4. The authority citation for part 140 continues to read as follows:

Authority: 7 U.S.C. 2(a)(12), 12a, 13(c), 13(d), 13(e), and 16(b).

■ 5. In § 140.93, add paragraph (a)(6) to read as follows:

§ 140.93 Delegation of authority to the Director of the Division of Swap Dealer and Intermediary Oversight.

(a) * * *

(6) All functions reserved to the Commission in §§ 23.150 through 23.159 of this chapter.

* * * * *

Issued in Washington, DC, on September 23, 2014, by the Commission.

Christopher J. Kirkpatrick,

Secretary of the Commission.

Note: The following appendices will not appear in the Code of Federal Regulations.

Appendices to Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants—Commission Voting Summary, Chairman's Statement, and Commissioner's Statement

Appendix 1—Commission Voting Summary

On this matter, Chairman Massad and Commissioners Wetjen, Bowen, and Giancarlo voted in the affirmative. No Commissioner voted in the negative.

Appendix 2—Statement of Chairman Timothy G. Massad

I support this proposed rule on margin requirements for uncleared swaps.

A key mandate of the Dodd-Frank Act was central clearing of swaps. This is a significant tool to monitor and mitigate risk, and we have already succeeded in increasing the overall percentage of the market that is cleared from an estimated 17% in 2007 to 60% last month, when measured by notional amount.

But cleared swaps are only part of the market. Uncleared, bilateral swap transactions will continue to be an important part of the derivatives market. This is so for a variety of reasons. Sometimes, commercial risks cannot be hedged sufficiently through clearable swap contracts. Therefore market participants must craft more tailored contracts that cannot be cleared. In addition, certain products may lack sufficient liquidity to be centrally risk-managed and cleared. This may be true even for products that have been in existence for some time. And there will—and always should be—innovation in the market, which will lead to new products.

That is why margin for uncleared swaps is important. It is a means to mitigate the risk of default and therefore the potential risk to the financial system as a whole. To appreciate the importance of the rule being proposed, we need only recall how Treasury and the Federal Reserve had to commit $182 billion to AIG, because its uncleared swap activities threatened to bring down our financial system.

The proposed rule requires swap dealers and major swap participants to post and collect margin in their swaps with one another. They must also do so in their swaps with financial entities, if the level of activity is above certain thresholds. The proposal does not require commercial end-users to post or collect margin, nor does it require any swap dealer or major swap participant to collect margin from or post margin to commercial end-users. This is an important point.

Today's proposal on margin also reflects the benefit of substantial collaboration between our staff and our colleagues at the Federal Reserve, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation, as well as significant public comment. The Dodd-Frank Act directs each of the prudential regulators to propose rules on margin for the entities for which it is the primary regulator, whereas the CFTC is directed to propose a rule for other

entities engaging in uncleared swap transactions. The Dodd-Frank Act also directed us to harmonize our rules as much as possible. Today's proposed rule is very similar to the proposal of the prudential regulators that was published recently. I want to again thank our staff, as well as the staffs of the prudential regulators, for working together so well to accomplish that task.

We have also sought to harmonize our proposal with rules being developed in Europe and Asia. Our proposed rule is largely consistent with the standards proposed by Basel Committee on Banking Supervision and the International Organization of Securities Commissions, and we have been in touch with overseas regulators as we developed our proposal.

The importance of international harmonization cannot be understated. It is particularly important to reach harmonization in the area of margin for uncleared swaps, because this is a new requirement and we do not want to create the potential for regulatory arbitrage in the market by creating unnecessary differences. Margin for uncleared swaps goes hand in hand with the global mandates to clear swaps. Imposing margin on uncleared swaps will level the playing field between cleared and uncleared swaps and remove any incentive not to clear swaps that can be cleared.

Proposing this rule is an important step in our effort to finish the job of implementing the Dodd-Frank Act and will help us achieve the full benefit of the new regulatory framework, while at the same time protecting the interests of—and minimizing the burdens on—commercial end-users who depend on the derivatives markets to hedge normal business risks.

We recognize that more stringent margin requirements impose costs on market participants, and therefore the proposal includes a detailed cost-benefit analysis. I believe the proposed rule balances the inherent trade-off between mitigating systemic risk and minimizing costs on individual participants. I look forward to having public feedback on that analysis, as well as on the proposal as a whole.

Appendix 3—Statement of Commissioner J. Christopher Giancarlo

I support the issuance of the proposed rules for uncleared margin. I look forward to reviewing well-considered, responsive and informative comments from the public. Seeking further public comment on this proposal is necessary given the passage of time and the further deliberations with our fellow regulators since the publishing of our 2011 proposal. For the same reasons, I urge the Commission to re-propose capital requirements for swap dealers and major swap participants, which are closely linked to the uncleared margin rules.

Uncleared over-the-counter swaps (OTC) and derivatives are vital to the U.S. economy. Used properly, they enable American companies and the banks they borrow from to manage changing commodity and energy prices, fluctuating currency and interest rates, and credit default exposure. They allow our state and local governments to manage their obligations and our pension funds to support healthy retirements. Uncleared swaps serve a key role in American business planning and risk management that cannot be filled by cleared derivatives. They do so by allowing businesses to avoid basis risk and obtain hedge accounting treatment for more complex, non-standardized exposures. While much of the swaps and OTC derivatives markets will eventually be cleared—a transition I have long supported—uncleared swaps will remain an important tool for customized risk management by businesses, governments, asset managers and other institutions whose operations are essential to American economic growth.

Advance Notice of Proposed Rulemaking: Cross-Border

I support the Commission's decision to issue an advance notice of proposed rulemaking to determine how the uncleared margin rule should apply extraterritorially. I have long advocated that the Commission take a holistic, global approach to the cross-border application of its rules. This approach should prioritize the critical need for international harmony and certainty for American businesses and other market participants. It is undeniable that the lack of such certainty in the Commission's cross-border framework is causing fragmentation of what were once global markets, increasing systemic risk rather than diminishing it. I therefore applaud the Commission's decision to seek public comment on the most optimal cross-border framework with respect to uncleared margin.

In light of the recent decision from the U.S. District Court for the District of Columbia holding that the Commission's cross-border guidance is non-binding and that the Commission will have to justify the cross-border application of its rules each time it brings an enforcement action,[1] it is important that the Commission provide swaps market participants with certainty on how the uncleared margin rule will apply extraterritorially.

I believe that the advance notice of proposed rulemaking for the cross-border application of the uncleared margin rules demonstrates a pragmatism and flexibility that belies the oft repeated notion that CFTC rulemaking widely and woodenly overreaches in its assertion of extraterritorial jurisdiction. I commend it to our fellow regulators abroad as a portent of greater accord in global regulatory reform.

I look forward to reading and addressing well-considered comments on the cross-border issues. In particular, I join Commissioner Wetjen in welcoming thoughtful comment and analysis on the potential competitive impacts associated with each of the different approaches identified in the advance notice of proposed rulemaking. I encourage commentators to quantify, if practical, and be specific about particular provisions or concerns.

Furthermore, I think this rulemaking should be a template for things to come. I urge the Commission to follow the Securities and Exchange Commission's (SEC) lead and replace its non-binding guidance with a comprehensive set of rules, supported by a rigorous cost-benefit analysis, delineating when activities outside the United States will have a direct and significant connection with activities in, or effect on, commerce in the United States. Good regulation requires nothing less.

Notwithstanding my support for the issuance of these proposed rules and the advance notice of proposed rulemaking on cross-border issues in order to solicit comment, I have a number of substantive concerns which I will now address.

Ten-Day Margin Requirement

Today's proposal requires collateral coverage on uncleared swaps equal to a ten-day liquidation period. This ten-day calculation comports with rules adopted recently by the U.S. prudential bank regulators. Yet, it still must be asked: Is ten days the right calculation? Why not nine days; why not eleven? Should it be the same ten days for uncleared credit default swaps as it is for uncleared interest rate swaps and for all other swaps products? Surely, all non-cleared swap products do not have the same liquidity characteristics or risk profiles. I encourage commenters to provide their input on these questions.

SEC Chair Mary Jo White recently stated: ''Our regulatory changes must be informed by clear-eyed, unbiased, and fact-based assessments of the likely impacts—positive and negative—on market quality for investors and issuers.''[2] Chair White's standard of assessment must surely apply to the proposed margin rule on uncleared swaps. Where is the clear-eyed assessment of the ten-day margin requirement? Where is the cost benefit analysis? What are the intended consequences? What will be the unintended ones? Will American swaps end users wind up paying for the added margin costs even though they are meant to be exempt? I would be interested to hear from commentators on this issue.

I am troubled by recent press reports of remarks by unnamed Fed officials that the coverage period may be intentionally ''punitive'' in order to move the majority of trades into a cleared environment.[3] I would

[1] *SIFMA* v. *CFTC,* No. 13–cv–1916 slip op. at 72 (D.D.C. Sept. 16, 2014).

[2] Phillip Stafford, *Sense of Urgency Underpins Fresh Scrutiny of Markets,* Financial Times, Sept. 16, 2014, available at *http://www.ft.com/intl/cms/s/0/a373646a-344b-11e4-b81c-00144feabdc0.html?siteedition=intl#axzz3DPM3AEzi.*

[3] Mike Kentz, *Derivatives: Fed backs off corporate margin requirements,* IFRAsia, Sept. 11, 2014, available at *http://www.ifrasia.com/derivatives-fed-backs-off-corporate-margin-requirements/21162697.fullarticle.*

be interested to review any considered analysis of the likely impact of the ten-day liquidation period and whether or not it may have a punitive effect on markets for uncleared swaps products.

Any punitive or arbitrary squeeze on non-cleared swaps will surely have consequences—likely unintended—for American businesses and their ability to manage risk. With tens of millions of Americans falling back on part-time work, it is not in our national interest to deter U.S. employers from safely hedging commercial risk to free capital for new ventures that create full-time jobs. It is time we move away from punishing U.S. capital markets toward rules designed to revive American prosperity. I look forward to reviewing well-considered comments as to the appropriateness of a ten-day liquidation period, as well as its estimated costs and benefits, particularly the impact on American economic growth.

End Users

As noted in the preamble, the Dodd-Frank Act requires the CFTC, the SEC, and the prudential regulators to establish comparable initial and variation margin requirements for uncleared swaps.[4] In 2011, however, the Commission and the prudential regulators issued proposals that varied significantly in several respects. In particular, the rules proposed by the prudential regulators in 2011 would have required non-financial end users to pay initial and variation margin to banks, while the Commission's rules exempted these entities in accordance with Congressional intent.[5]

I am pleased that the prudential regulators have moved in the CFTC's direction and will not require that non-financial end users pay margin unless necessary to address the credit risk posed by the counterparty and the risks of the swap.[6] It is widely recognized that non-financial end users, that generally use swaps to hedge their commercial risk, pose less risk as counterparties than financial entities. It is my hope that upon finalization of these rules, swap dealers and major swap participants will treat non-financial end users consistently when it comes to margin, no matter which set of rules apply.

Threshold for Swaps Exposure

I am also pleased that our collaboration with the BCBS/IOSCO[7] international working group has resulted in proposed rules that are largely harmonious with the 2013 international framework. There is a particular and significant difference that troubles me, however. The CFTC and the prudential regulators have set the threshold for material swaps exposure by financial end users at $3 billion, while the 2013 international framework sets the threshold at €8 billion (approximately $11 billion). This means that a whole middle-tier of American financial end users could be subject to margin requirements that will not be borne by similar firms overseas. It may well limit the number of counterparties willing to enter into swaps with these important lenders to American business. I am concerned that this could potentially reduce the utility of risk reducing strategies for a class of middle-tier, U.S. financial institutions that have already been hit hard by new capital constraints, among other rules.

In this time of dismal economic growth, it is hard to justify placing higher burdens on America's medium-sized financial firms than those their overseas competitors face. We have not, in my opinion, sufficiently addressed in our cost benefit analysis the impact of this threshold difference on American firms and their customers. Where is the clear-eyed analysis of the impact of this rule on the American economy? I hope that the Commission will not perpetuate this divergence in the final rules without carefully weighing the costs and benefits. I encourage commenters to address this point and to supply any data and analysis that may be illuminating. It is time our rules were designed less to punish and more to promote U.S. capital markets. Punishment as a singular regulatory policy is getting old and counterproductive. It is time our rules focused on returning America to work and prosperity.

Increase Reliance on International Collaboration

Similarly, I want to echo Commissioner Wetjen's call for comments on two areas where the Commission can harness international collaboration. First, I welcome comments on whether the Commission should exclude from the scope of this rulemaking any derivative cleared by a central counterparty (CCP) that is subject to regulation and supervision consistent with the CPSS–IOSCO Principles for Financial Market Infrastructures (PFMIs), an alternative on which the Commission seeks comment in the preamble. It is reported that at least one U.S. financial firm is a member at 70 different CCPs around the globe. The present proposal, if finalized, could result in trades cleared on many of these CCPs being treated as if they are uncleared.[8] This would seem to be a needlessly costly and burdensome imposition on American commerce. Global regulators have already agreed on international standards in the PFMIs to determine how CCPs should be regulated and supervised. It makes sense to leverage these standards where we can. I encourage comment on this issue.

I would also be interested in commenters' views on how the Commission should conduct its comparability analysis under this rulemaking. In the advance notice of proposed rulemaking, the Commission proposes to permit market participants to comply with foreign rules, if such rules are comparable to the Commission's margin requirements. Yet, a better approach may be to compare a foreign regime to the international standards put forward by the BCBS/IOSCO international working group that included participation from over 20 regulatory authorities. Doing so would give the Commission some comfort that foreign rules meet a necessary baseline, but could avoid unnecessary and potentially destabilizing disputes over comparability in the future. I hope the insights of interested parties will guide not only the Commission, but also the prudential regulators. I further hope all concerned parties can use this rulemaking as an opportunity to promote international comity at a time when it is sorely needed.

Treatment of Small Financial Entities

Another aspect of the proposed rules that concerns me is the treatment of financial entities that qualify for the small bank exemption from clearing and financial cooperatives. Section 2(h)(7)(C)(ii) of the CEA directed the Commission to consider whether to exempt from the definition of "financial entity" small banks, savings associations, farm credit system institutions and credit unions with total assets of $10 billion or less. In response, the Commission exempted these small financial institutions from the definition of financial entity for purposes of clearing. It recognized that these institutions serve a crucial function in the markets for hedging the commercial risk of non-financial end users. Moreover, the Commission acknowledged that the costs associated with clearing, including margin and other fees and expenses, may be prohibitive relative to the small number of swaps these firms execute over a given period of time.[9] In addition, using its Section 4(c) exemptive authority, the Commission permits cooperative financial entities, including those with total assets exceeding $10 billion, to elect an exemption from mandatory clearing for swaps executed in connection with originating loans for their members, or that hedge or mitigate commercial risk related to loans or swaps with their members.[10]

Despite the CFTC's otherwise appropriate treatment of these small banks and financial cooperatives, the proposed margin rules treat them as financial institutions required to post

[4] CEA section 4s(e)(3)(D)(ii).

[5] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 FR 23732, 23736–37 (Apr. 28, 2011).

[6] The prudential regulator's proposal contains the following provision: "A covered swap entity is not required to collect initial margin with respect to any non-cleared swap or non-cleared security-based swap with a counterparty that is neither a financial end user with material swaps exposure nor a swap entity but shall collect initial margin at such times and in such forms (if any) that the covered swap entity determines appropriately address the credit risk posed by the counterparty and the risks of such non-cleared swaps and non-cleared security-based swaps." Margin and Capital Requirements for Covered Swap Entities, slip copy at 167, available at *http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20140903c1.pdf.* This is somewhat different, but not inconsistent with the Commission's proposal, which will allow the parties to exchange margin by agreement, or to arrange other types of collateral agreements consistent with their needs.

[7] Basel Committee on Banking Supervision/International Organization of Securities Commissions.

[8] Sam Fleming and Phillip Stafford, *JPMorgan Tells Clearers to Build Bigger Buffers,* Financial Times, Sept. 11, 2014 available at *http://www.ft.com/intl/cms/s/0/48aa6b02-38f9-11e4-9526-00144feabdc0.html#axzz3DPM3AEzi.*

[9] End-User Exception to the Clearing Requirement for Swaps, 77 FR 42560, 42578 (Jul. 19, 2012); 17 CFR 50.50(d).

[10] Clearing Exemption for Certain Swaps Entered into by Cooperatives, 78 FR 52286 (Aug. 22, 2013); 17 CFR 50.51.

margin when their swaps exposure exceeds the $3 billion threshold. This means that small banks and cooperative financial institutions entitled to a clearing exemption will have to pay margin for their uncleared activity with swap dealers or major swap participants when they have material swaps exposure. It makes no sense to provide these entities with an exemption from clearing on the one hand, only to turn around and require them to bear the potentially even greater costs associated with uncleared swaps. They deserve the full benefit of their clearing exemption, which they may not get if they have to post margin. I encourage comment on this issue, which I will weigh carefully in the process of considering a final rule.

Inter-Affiliate Exemption

The proposed rules may also diminish the utility of the critically important, inter-affiliate clearing exemption the Commission adopted last year for certain eligible affiliate counterparties.[11] The exemption was premised on recognition that transactions between affiliates do not present the same risks as market-facing swaps, and generally provide risk-mitigating, hedging, and netting benefits within a corporate group.[12] I welcome comments addressing the impact the proposed rules may have on the ability of affiliated entities to efficiently manage their risk.[13]

Use of Approved Models to Calculate Capital

Finally, I believe it is important to allow the use of models when calculating initial margin. The proposed rules require the Commission's prior written approval before a model can be used, even though the Commission lacks adequate staff and expertise for evaluating models. We recognize in the preamble that many covered swap entities are affiliates of entities whose margin models are reviewed by one of the prudential regulators, the SEC, or a foreign regulator, and to avoid duplicative efforts we plan to coordinate with other regulators in an effort to expedite our review. Rather than go through a special approval process, however, I believe we should accept models approved by our fellow regulators, so long as they contain the required elements. Alternatively, as mentioned in the preamble and discussed at the open meeting, this may be an area in which the National Futures Association can provide assistance, and I am interested in hearing its views on the issue. I also join Commissioner Wetjen's call for discussion on the circumstances in which the Commission may permit market participants to continue using models while Commission staff is reviewing them. Given the CFTC's limited resources, I believe we should make every effort to leverage the expertise of other qualified regulators before asking for more tax dollars from Americans working two jobs just to stay afloat.

Conclusion

In spite of my stated concerns, I support the issuance of these proposed rules in order to solicit comment. They raise a number of important issues, particularly in their impact on the U.S. economy and job creation and the extent of their application across the globe. It is vital that we hear from interested parties on how to get them right. I commend the Chairman and my fellow Commissioners for their thoughtfulness and open-mindedness in arriving at the final proposals. I look forward to receiving and reviewing comments on the issues discussed above and all aspects of the rules.

[11] Clearing Exemption for Swaps Between Certain Affiliated Entities, 78 FR 21750 (Apr. 11, 2013); 17 CFR 50.52.

[12] *Id.* at 21751–54.

[13] Separately, I also welcome comments on the sufficiency of the no-action relief issued by the Division of Clearing and Risk for swaps entered into by treasury affiliates, and whether it may serve as a model for future rulemaking to provide greater certainty in this area. *See* CFTC Letter No. 13–22 (Jun. 4, 2013).

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