

CLIENT ALERT

The CFTC's Cross-Border Margin Proposal: What Investment Funds Need to Know

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On June 29, the CFTC proposed new standards for the application of its proposed margin rules (the "Margin Proposed Rules") to swap transactions where one or more of the counterparties is located outside the U.S. (the "New Margin Cross-Border Proposal").

The application of the Margin Proposed Rules has been particularly complex and contentious in the cross-border context. The New Margin Cross-Border Proposal proposes to narrow in certain respects, but broaden in other respects, the application of the Margin Proposed Rules to investment funds and other collective investment vehicles. For example, the New Margin Cross-Border Proposal excludes non-U.S. organized investment funds and other collective investment vehicles (even if majority owned by U.S. persons) from the scope of the Margin Proposed Rules, unless they are managed in the U.S. On the other hand, the New Margin Cross-Border Proposal expands previous CFTC proposed guidance by requiring application of the Margin Proposed Rules where a swap transaction is executed "by or through" a U.S. office of a non-U.S. swap dealer, unless certain exceptions apply. This may impact funds' choice of counterparties through which they execute swaps.

What should funds do now? In addition to considering the impact of the Margin Proposed Rules and the New Margin Cross-Border Proposal on their operations, funds should consider whether they want to comment on the New Margin Cross-Border Proposal or otherwise seek to become involved in the policy process around regulation of margin generally.

This Client Alert is focused on the potential impact of the New Margin Cross-Border Proposal on investment funds. The New Margin Cross-Border Proposal also impacts many other participants in the swaps market. Please contact one of the professionals listed below, or your regular Crowell & Moring contact for more information.

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By way of background, subject to certain exceptions, once approved in final form, the Margin Proposed Rules will require swap dealers and major swap participants that are not regulated by a banking regulator (collectively, "CSEs") to post and collect initial and variation margin on uncleared swaps with, among other market participants, private funds, investment companies, commodity pool operators, investment advisers, commodity trading advisers, broker-dealers, securities holding companies and other so-called "financial end users." (CSEs regulated by a banking regulator are subject to similar margin rules proposed by the banking regulators.) The Margin Proposed Rules will also establish minimum levels of initial and variation margin that must be posted and collected, establish eligibility requirements for this collateral, bar rehypothecation of initial margin and impose other limitations and requirements.

Why should funds be concerned with the Margin Proposed Rules? Subject to certain exceptions, the Margin Proposed Rules would require swap dealers and major swap participants that are not regulated by a banking regulator (collectively, "CSEs") to post and collect initial and variation margin on uncleared swaps with, among other market participants, private funds,

investment companies, commodity pool operators, investment advisers, commodity trading advisers, broker-dealers, securities holding companies and other so-called "financial end users." "Private funds," or funds excluded from registration under Sections 3(c)-1 or 3(c)-7 of the Investment Advisers Act, make up a significant swath of the private hedge fund and other similar fund industry and would be considered "financial end users." The Margin Proposed Rules would also establish minimum levels of initial and variation margin that must be posted and collected, establish eligibility requirements for this collateral, bar rehypothecation of initial margin and impose other limitations and requirements.

The New Margin Cross-Border Proposal clarifies when the Margin Proposed Rules apply to swap transactions where one or more of the counterparties is a non-U.S. person and differs from the CFTC's previously issued guidance on cross-border swaps (the "Old Cross-Border Guidance").

What is the impact of the New Margin Cross-Border Proposal on funds with U.S. investors? Non-U.S. organized investment funds and other collective investment vehicles (even if majority owned by U.S. persons) will not be considered "U.S. persons" unless they fall into specified categories, including funds that are organized under U.S. law or whose principal place of business is in the U.S..

Under the New Margin Cross-Border Proposal, the following categories of individuals or entities (among others) are considered "U.S. persons":

- (i) A natural person who is a resident of the United States;
- (ii) A corporation, partnership, limited liability company, trust, fund or other type of entity organized or incorporated under the laws of the United States or having its principal place of business in the United States, including any branch of such legal entity;
- (iii) A pension plan for the employees, officers or principals of a U.S. legal entity, unless the pension plan is primarily for foreign employees of such entity; or
- (iv) A legal entity (other than an entity where all of the owners have limited liability) that is owned by one or more other U.S. persons and for which such person(s) bears unlimited responsibility for the obligations and liabilities of the legal entity, including any branch of the legal entity.

What transactions require funds to post margin under the Margin Proposed Rules and the New Margin Cross-Border Proposal? The New Margin Cross-Border Proposal requires the Margin Proposed Rules to be implemented differently based on characteristics of the counterparties to a particular swap transaction, including:

- whether the counterparties to the swap are U.S. or non-U.S. persons;
- whether either of the counterparties is part of a consolidated group of entities whose ultimate parent is a U.S. person (a "foreign controlled subsidiary" or "FCS"); and
- whether or not either counterparty's obligations under the particular swap transaction are guaranteed by a U.S. person.

Application of Margin Proposed Rules to Cross Border Transactions		
U.S. Person Status of Fund	U.S. Person Status of CSE Counterparty	Application of Margin Rules
U.S. person, or non-U.S. person whose obligations under the swap are guaranteed by a U.S. person	U.S. CSE, or non-U.S. CSE (including a U.S. branch of a non-U.S. CSE) whose obligations under the swap are guaranteed by a U.S. person	U.S. rules apply, with no substituted compliance available
Non-U.S. person whose obligations under the swap are not guaranteed by a U.S. person	U.S. CSE or non-U.S. CSE whose obligations under the swap are guaranteed by a U.S. person	U.S. rules apply for collection of initial margin by the CSE/posting by the fund, and for both posting and collection of variation margin Substituted compliance may be available for posting of initial margin by the CSE/collection by the fund
Any	CSE that is a foreign controlled subsidiary of a U.S. person, or that is a U.S. branch of a non-U.S. CSE, whose obligations under the swap are not guaranteed by a U.S. person	Substituted compliance may be available for all margin requirements
Non-U.S. person that is not a foreign controlled subsidiary of a U.S. person, and whose obligations under the swap are not guaranteed by a U.S. person	Non-U.S. CSE that is not a foreign controlled subsidiary of a U.S. person, and not a U.S. branch of a non-U.S. CSE, and whose obligations under the swap are not guaranteed by a U.S. person	CFTC margin rules do not apply

Note that this chart assumes that the fund itself is not a swap dealer or major swap participant.

Are the Margin Proposed Rules applicable to a fund's transactions with a non-U.S. affiliate of a U.S. person? In the New Margin Cross-Border Proposal, CSEs that are foreign controlled subsidiaries are subject to the CFTC's margin requirements, although substituted compliance may be available. This is true whether or not the non-U.S. CSE's obligations are guaranteed by a U.S. affiliate. This is a departure from the Old Cross-Border Guidance, which divided CSEs into "guaranteed affiliates" and "non-guaranteed affiliates." However, under the New Margin Cross-Border Proposal, a transaction by a non-U.S. CSE that is not a foreign controlled subsidiary will still be subject to the CFTC's rules if the non-U.S. CSE's obligations under that particular swap are guaranteed by a U.S. person.

Are the Margin Proposed Rules applicable to swap transactions conducted in the U.S. by non-U.S. persons? Under the New Margin Cross-Border Proposal, if a swap transaction is executed "by or through" a U.S. office of a non-U.S. CSE, even if that non-U.S. CSE is not a foreign controlled subsidiary of or guaranteed by a U.S. person, the Margin Proposed Rules will still apply unless substituted compliance is available. This is similar to what some refer to as the "elevator rule" – the CFTC's position in Staff Advisory 13-69 that swap transactions between a non-U.S. CSE and its non-U.S. counterparty are nonetheless subject to the CFTC's external business conduct and other transaction-level requirements if they are "arranged, negotiated or executed" by U.S. personnel of the non-U.S. CSE. The effectiveness of 13-69 has been delayed by No-Action Letter a number of times, so it is not clear whether the similar provision in the New Margin Cross-Border Proposal will survive.

When is substituted compliance available? "Substituted compliance" with the margin rules of a non-U.S. jurisdiction will theoretically be available for some swap transactions. However, before swap participants can comply with non-U.S. margin rules to the exclusion of the CFTC's rules, the CFTC must make a determination that the applicable non-U.S. jurisdiction's rules are "substantially comparable" to the U.S. rules.

When will counterparties be required to post margin under the CFTC rules? The Margin Proposed Rules will not become effective until the publication of the final rules in the Federal Register. Assuming the Margin Proposed Rules become effective as proposed, the first variation margin will be required to be posted in December 2015. The New Margin Cross-Border Proposal does not change this deadline. However, recent proposals by the BCBS/IOSCO group of global regulators would extend this deadline to September 1, 2016.

What should investment funds do now? First, investment funds should consider the potential impacts of the Margin Proposed Rules and the New Margin Cross-Border Proposal on their trading strategies, trading costs and universe of potential counterparties for trading uncleared swaps. Second, funds should consider establishing custodial relationships with unaffiliated custodial banks to hold margin required to be collected from swap dealers. Finally, to the extent investment funds view the Margin Proposed Rules and the New Margin Cross-Border Proposal as having a negative impact on their business, investment funds should consider commenting on the New Margin Cross-Border Proposal or otherwise becoming involved in the public policy process.

Crowell & Moring's regulatory attorneys and public policy group are available to discuss the impact of the Margin Proposed Rules, and the implications of the New Margin Cross-Border Proposal, on market participants and to assist in providing comments to the CFTC or other regulators. In addition, Crowell & Moring's attorneys are available to assist participants in the swaps market in analyzing their risk exposure to the proposed rule, and in ensuring that swap transactions comply with applicable laws.

The full text of the New Margin Cross-Border Proposal can be found [here](#). Comments are due 60 days after its publication in the Federal Register.

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.

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