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ISDA®

Guide to the Cross-border Application of US, EU and Japan Margin Rules for Non-cleared Derivatives

A large number of counterparties will come into scope of initial margin (IM) requirements for non-cleared derivatives in 2020 and 2021. This has increased the focus on the applicability of the rules to cross-border trading relationships.

However, there are practical challenges in analyzing multiple foreign rule sets and identifying situations in which different rules will apply, as well as understanding whether substituted compliance is available to reduce the compliance burden. Firms will need to understand the different aggregate average notional amount (AANA) calculations that are relevant to them, the IM thresholds that apply to their trading relationships, and the substantive requirements they will have to meet.

This guide describes the cross-border and substituted compliance rules under different margin regimes, and uses that framework to examine the applicable rules for the US, the European Union (EU) and Japan. It focuses on the position of an entity that is not a swap dealer but is either directly subject to margin rules or is obliged to comply with the margin requirements of its counterparties.

Cross-border Impact of the Margin Regulations[1]

Margin rules require action by both counterparties to a trading relationship, which imposes direct and indirect costs on both parties, even if the regulations only apply to one of them. One party's regulatory obligation to collect collateral will result in the other party's contractual obligation to post collateral, which will impose funding, operational and set-up costs.

The cross-border impact of margin rules is potentially significant. Derivatives markets are global, and counterparties often trade in overseas jurisdictions that may each have their own margin rules. This means a firm trading with counterparties in different jurisdictions may need to analyze and comply with different rule sets for similar transactions. If multiple, non-identical sets of rules apply to a single trading relationship, the parties will need to comply with all applicable obligations, resulting in requirements that are stricter than any individual rule set. These effects may be more pronounced for IM than for variation margin (VM). While substituted compliance may mitigate these effects, it is not always available.

Determining whether rules apply to a foreign entity will often require a counterfactual analysis – in other words, considering the rules that would apply to the entity if it were located in the relevant jurisdiction. This requires analysis of regulations that do not apply to the foreign entity directly, and with which the foreign entity is likely unfamiliar. Substituted compliance can help reduce the burden, but it is not always available in cross-border situations, so this type of analysis will still need to be undertaken in many cases.

Scope of Paper

The scope of this guide is limited to legal entities, and so does not consider any provisions of the margin rules relating to natural persons. It examines general rules for the cross-border application of margin requirements and the availability of substituted compliance[2]. Some margin rules have special cross-border provisions for affiliated entities, or entities in jurisdictions where netting or margin segregation is not enforceable. Those special cases are not covered in this guide unless they are an integral part of the cross-border rules (Japan is the only current example of this).

The rules examined in this guide include:

- The US Commodity Futures Trading Commission (CFTC);
- The US prudential regulators, comprising the Office of the Comptroller of the Currency, the Federal Reserve System, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency;
- The US Securities and Exchange Commission (SEC);
- The European Commission (EC); and
- The Japan Financial Services Agency (JFSA).

[1] This guide, including the diagrams, is intended to provide a general overview of cross-border application of certain margin rules for non-cleared derivatives. It should not be considered legal advice or analysis. Market participants should obtain their own legal advice before taking any action based upon this guide. This guide does not address the full detail of the cross-border application of each set of margin rules described herein or their implications

[2] In this guide, a reference to substituted compliance being 'available' means the parties can benefit from a comparability or equivalence determination, based on the rules of the margin regime and assuming no additional conditions are imposed in the comparability/equivalence determination. Whether substituted compliance can be used in a specific case will also typically depend on whether a relevant comparability or equivalence determination has been made and, if so, whether it imposes any additional conditions

Conceptual Approach and Taxonomy

The use of distinct terminology and concepts in different margin rules complicates the analysis of cross-border requirements. First, it requires review of more than one legal system and the reconciliation of requirements between the two regimes, which may be similar in outcome but expressed in very different ways. Second, margin rules often follow local law conventions and sometimes rely on existing regulatory classifications, necessitating some understanding of regulations outside the margin rules.

It is helpful that most regimes have based their rules on the Basel Committee on Banking Supervision (BCBS) and International Organization of Securities Commissions (IOSCO) Working Group on Margining Requirements (WGMR) framework, but there remains significant scope for differences, notably in the definitions of regulated entities, covered counterparties, in-scope transactions and eligible collateral.

The cross-border provisions themselves are also expressed in different ways, even if they have similar goals. For example, some rules apply directly to foreign entities, and so the cross-border provisions limit the application of rules to those foreign entities. Other rules only apply to domestic entities, so the cross-border requirements expand the application to foreign entities. To compare the different cross-border rules, it is therefore necessary to define a consistent conceptual approach and taxonomy.

Each set of margin rules is a 'margin regime'. Each margin regime is enacted by an authority in a 'jurisdiction'. In some cases, there are multiple margin regimes in a single jurisdiction, because multiple regulators in a single jurisdiction have authority over different entities.

Each margin regime defines the entities that are directly subject to it. An entity meeting those requirements is referred to as a 'regulated entity' for that regime. For IM, this generally means the entity exceeds any applicable AANA threshold and does not fall within an exception to the margin requirements.

Each margin regime also defines the scope of trading counterparties for which regulated entities need to apply the margin requirements. A counterparty that meets all the relevant requirements is referred to as a 'covered counterparty' for that regime. For IM, this generally means the entity exceeds any applicable AANA threshold and does not fall within an exception to the margin requirements. Covered counterparties typically include other regulated entities.

A firm is a 'domestic' entity for a jurisdiction and its margin regime if it is incorporated, organized or established in that jurisdiction. An institution is a 'foreign' entity if it is incorporated, organized or established in a different jurisdiction.

This guide looks strictly at the legal entity level to determine whether an institution is domestic or foreign. So, if a US group has a trading subsidiary that is established in France and registered with the CFTC as a swap dealer, then the EU would be the domestic jurisdiction for that French legal entity and the US would be a foreign jurisdiction. Note that both regulated entities and covered counterparties under a jurisdiction's margin rules may be domestic or foreign[3].

[3] As will be discussed later, the scope of regulated entities under a regime may be limited to domestic entities and covered counterparties may be limited to foreign entities. In these cases, it is technically redundant to refer to a 'domestic' regulated entity or a 'foreign' covered entity, but this terminology will be used throughout for consistency

An entity may have branches in different jurisdictions, so a domestic firm may have foreign branches and a foreign entity may have domestic branches. Any act of an institution's branch is considered to be an act of that entity, unless otherwise noted. For example, a transaction entered into with the foreign branch of a domestic firm is a transaction with a domestic entity.

An institution may have affiliates, including parent or subsidiary entities. The act of an affiliate of an entity is not considered an act of that entity. However, the status of an institution's affiliates may affect whether the margin rules of a jurisdiction apply. In particular, the AANA will be calculated based on the amount of non-cleared derivatives of a group as a whole.

Different Models for Identifying Regulated Entities and Covered Counterparties

All margin regimes to a greater or lesser extent require financial firms and systemically important non-financial entities to exchange collateral based on the BCBS-IOSCO WGMR framework by categorizing these firms as regulated entities or covered counterparties. But the approach to defining regulated entities and covered counterparties can be quite different.

In order to understand how margin rules apply on a cross-border basis, it is helpful to distinguish different models of applying margin rules to legal entities – ie, how regulated entities and covered counterparties are defined.

In all the models outlined, the rules apply directly only to regulated entities, but those regulated entities must enter into contractual relationships with covered counterparties. This makes the margin requirements legally binding on the covered counterparty indirectly by contract. As a result, while these distinctions are important to understand how the cross-border rules operate, they are not significant from a policy perspective.

There are two main models for regulated entities.

- Entities globally are required to register based on derivatives dealing activity with some connection to the domestic jurisdiction, and must comply with the margin requirements.

- Entities that are organized or operate through a local branch in the domestic jurisdiction, or are managed by an entity in the local jurisdiction, are required to comply with margin requirements.

The first model is used under US rules, while the second is typically used by other jurisdictions. The first model can include foreign entities operating completely outside the domestic jurisdiction, and so has greater potential scope for cross-border application. The second model can include entities that are not derivatives dealers and so covers a broader range of businesses.

There are two main models for covered counterparties.

- Certain categories of covered counterparties are defined exclusively (typically with certain exclusions), so an entity is only a covered counterparty if it is in one of the categories and not an excluded entity.

- All entities are defined as covered counterparties, unless they fit within an exclusion.

The rules issued by the CFTC, US prudential regulators, the EU and Japan follow the first model, while the SEC is unique in using the second. Under US rules, the scope of covered counterparties is much broader than regulated entities. Under EU and Japan rules, the scope of domestic regulated entities and domestic covered counterparties is the same. For a domestic in-scope trading relationship, both parties will therefore be regulated entities directly subject to the rules.

The first model has an exclusive definition of covered counterparties, and so margin regimes using it must define both domestic and foreign covered counterparties. To the extent covered counterparties are defined by reference to domestic regulatory categories, a rule is needed to identify foreign covered counterparties. This is typically a counterfactual analysis (the regulatory category that the foreign entity *would* be in if it *were* a domestic entity), which can be complex to perform. To the extent covered counterparties are defined by a quantitative portfolio/trading size test, no special rule is needed, although a currency conversion of the counterparty's activity may be required.

The second model does not have an exclusive definition of covered counterparties, so foreign entities will be covered counterparties unless they meet the conditions of an exclusion. This can reduce complexity, but may expand the scope for the rules to apply, both domestically and cross-border.

Different Approaches to Cross-border Application and Substituted Compliance

As explained in the BCBS-IOSCO WGMR framework, margin requirements for non-centrally cleared derivatives are expected to reduce systemic risk (contagion and spillover effects) by ensuring that collateral is available to offset losses caused by the default of a derivatives counterparty. They can also have broader macro-prudential benefits, by reducing the financial system's vulnerability to potentially destabilizing pro-cyclicality and limiting the build-up of uncollateralized exposures within the financial system. The imposition of margin requirements for non-cleared derivatives is also intended to promote central clearing.

It is recognized that risk to domestic entities, and therefore to the domestic financial system, can arise from both foreign and domestic trading activity. Regulators therefore have an interest in regulating cross-border and domestic transactions. But there are also strong policy reasons to defer to the rules of foreign jurisdictions, such as allowing for competition in foreign and domestic markets and international comity. The agreement to adopt margin requirements through the Group of 20 and BCBS-IOSCO demonstrates the importance of applying consistent margin rules in all major financial markets.

Deference to foreign jurisdictions can take two forms. First, cross-border rules determine the extent to which domestic rules apply to the activities of foreign entities. The exclusion of any trading relationships between foreign and domestic entities from local margin requirements therefore implies complete deference to any relevant foreign regulators to determine the margin requirements for those relationships. Second, substituted compliance can allow firms subject to domestic rules to apply a foreign regime instead, typically after that regime has been found to have comparable or equivalent requirements to the domestic rules. This implies partial deference and, depending on conditions of use, can allow a domestic regulator to calibrate the amount of deference given to a foreign margin regime.

There are two basic approaches to the cross-border application of margin rules.

- Apply domestic rules to a regulated entity when trading with a covered counterparty based on a connection[4] with the domestic jurisdiction of *either* the regulated entity *or* the covered counterparty.
- Apply domestic rules to a regulated entity when trading with a covered counterparty based *only* on a connection of the regulated entity with the domestic jurisdiction.

[4] Various types of connections of an entity to a domestic jurisdiction are used in different margin regimes, such as the laws under which the entity is organized, its principal place of business, the location of any parent or guarantor of the entity, etc

The first approach is used by all the regimes considered in this guide, although some other regimes follow the second approach. The key difference is whether the domestic regime applies when local covered counterparties (not directly subject to margin requirements) trade with foreign regulated entities (not acting through a domestic branch). The second approach defers to foreign jurisdictions to impose any margin requirements on foreign regulated entities when facing domestic covered counterparties.

There are also two basic approaches to allowing substituted compliance after any necessary substituted compliance determination has been made.

- Allow a domestic or foreign regulated entity trading with a foreign covered counterparty to apply the overseas regime of the covered counterparty's jurisdiction.

- Allow a foreign regulated entity to apply its home regime for trading with domestic covered counterparties (and, if the domestic rules apply, to trading with foreign covered counterparties).

There are several possible variations within these two basic approaches to substituted compliance.

- It may be sufficient for the regulated entity or covered counterparty to be located in the foreign jurisdiction for substituted compliance to be available. Alternatively, the substituted compliance rules may require either the foreign entity to be subject to obligations under the foreign regime, or the specific transaction to be subject to the foreign regime.

- A second variation is whether an entity is required to be located in the relevant foreign jurisdiction, or whether it is sufficient for the foreign jurisdiction's rules to apply to the entity. (Because of the cross-border application of the rules, an entity may be subject to margin rules of a jurisdiction even though neither party is located there. In some cases, this will mean that a trading relationship between two domestic entities could be subject to a foreign margin regime.)

- A third alternative is whether the rules dictate the foreign regime that may be followed (eg, the home regime of the counterparty), or whether it allows parties a choice of which regime to apply. This could be because both entities are subject to margin rules and substituted compliance is available under both regimes. It can also occur where an entity is subject to multiple foreign regimes (due to cross-border application).

- Another variation is to allow substituted compliance only for a limited set of margin obligations for certain entities (for example, restricting a domestic regulated entity's use of substituted compliance to the posting of initial margin).

These variations are used to calibrate the effect of substituted compliance, and reduce or increase the amount of deference to foreign regimes. Therefore, there is a spectrum where the benefits of deference are balanced against potential divergence from domestic policy. At one end of the spectrum, the aim may be solely to avoid duplicative rules applying to a single transaction, but otherwise ensure margin is exchanged for all transactions subject to the domestic regime. At the other end of the spectrum, the aim may be to provide primarily for margin regulation of domestic activity, and defer to foreign margin regimes to provide comparable regulation of cross-border activity, including determining which precise scope of entities and transactions should be subject to the requirements.

Cross-border Application of Rules and Availability of Substituted Compliance

The following sections analyze the cross-border application of margin rules and the availability of substituted compliance under US rules (the prudential regulators, CFTC and SEC), EU regulations and Japanese requirements.

This can be used by a foreign entity (Party B) potentially coming into scope of IM requirements to understand:

- Whether a margin regime potentially applies on a cross-border basis to a regulated entity under that regime (Party A) when facing Party B;
- If so, whether substituted compliance may be available; and
- If not, the analysis Party B will need to undertake to determine whether it is a covered counterparty under that margin regime.

This will help Party B determine which AANA calculations it may have to run and to plan for compliance.

It can also be used by a domestic regulated entity to consider the scope of foreign covered counterparties and determine when substituted compliance may be available. Party A's possible relationships with different covered counterparty types are shown in the charts in the appendix.

Note that all the analysis is at the legal entity level. For a corporate group, the analysis would need to be performed separately for each legal entity.

US

There are three separate sets of margin rules in the US: those of the SEC, the CFTC and the prudential regulators. The US margin regimes define regulated entities by registration requirements under the Dodd-Frank Act for swap dealers (SDs), major swap participants (MSPs), security based swap dealers (SBSDs) and major security based swap participants (MSBSPs). These registration requirements can include domestic and foreign regulated entities.

While the rules published by the CFTC and the prudential regulators are generally similar, there are significant differences with the SEC rules, so it is important to know which rules apply.

- With one exception, the prudential regulators' margin regime applies to the swaps and security based swaps of an SD, MSP, SBSD or MSBSP that has a prudential regulator.
- The CFTC margin regime applies to the swaps of an SD or MSP that does not have a prudential regulator.
- The SEC margin regime applies to the security based swaps of an SBSD or MSBSP that does not have a prudential regulator.
- The one exception noted above is that the SEC's segregation rules apply to an SBSD or MSBSP that has a prudential regulator.
    - The SEC's segregation rules provide a general exemption for certain SBSDs, which may limit their application in practice.

- There is also an ability for certain SBSDs that are also SDs to comply with the CFTC margin and segregation (and capital) rules with respect to their security based swaps in lieu of the SEC rules. An entity making this election would follow the CFTC cross-border rules in place of the SEC cross-border rules.

The starting point for analyzing the cross-border application of the US rules is that they apply to domestic and foreign regulated entities when facing domestic or foreign covered counterparties, unless a cross-border exclusion applies or substituted compliance is available.

Cross-border Application – CFTC and Prudential Regulators' Rules

The cross-border margin rules issued by the CFTC and prudential regulators generally exclude a foreign regulated entity when trading with foreign covered counterparties. But there are some important carve-outs[5] from this general exemptive approach. Specifically, the rules will apply when both the regulated entity and covered counterparty are foreign entities and:

- The regulated entity is a foreign subsidiary of a US entity;
- The regulated entity is trading from a US branch;
- The regulated entity or covered counterparty is guaranteed by a US entity (or certain other entities linked to the US[6]);
- Under the CFTC rules, either the regulated entity or the covered counterparty has a principal place of business in the US;
- Under the CFTC rules, the relevant swap between the foreign regulated entity and covered counterparty is not covered by a CFTC comparability determination and the regulated entity transfers the risk of that swap to an affiliate that is either a domestic regulated entity or a foreign regulated entity guaranteed by a US entity.

Two noticeable requirements are:

- Foreign regulated entities that are subsidiaries of US entities are subject to US rules even when facing foreign covered counterparties.
- Under the CFTC rules, foreign investment funds that are managed from the US are considered to have a principal place of business in the US and are therefore treated as domestic entities.

Substituted Compliance – CFTC and Prudential Regulators' Rules

Substituted compliance may be available under the rules published by US prudential regulators and the CFTC, but only in limited circumstances. While the cross-border application of the rules depends on the location of the regulated entity or the covered counterparty (or any guarantors), the availability of substituted compliance generally only depends on the location of the regulated entity (or any guarantor of the regulated entity).

[5] In addition to these carve-outs, the CFTC rules will also apply when the counterparty is also a covered swap entity and is acting through a US branch or is a subsidiary of a US entity. The rules published by US prudential regulators will also apply when the counterparty is a US branch of a foreign bank, or a swap entity that is a subsidiary of a US entity

[6] Under the rules published by US prudential regulators, these other guarantors would include a US branch of a foreign bank or a regulated entity that is a subsidiary of a US entity. Under the CFTC rules, these other guarantors would include a foreign entity with a principal place of business in the US

- A domestic regulated entity will typically not be able to use substituted compliance, even if either party is also required to apply a foreign regime.
  - There is a limited ability to use substituted compliance for an obligation to post IM to a foreign covered counterparty[7] that is not guaranteed by a US entity (or certain other entities linked to the US[8]). If the foreign covered counterparty is subject to a foreign margin regime requiring it to collect IM from the domestic regulated entity, the regulated entity can use substituted compliance to post only the amount the covered counterparty is required to collect.
- A foreign regulated entity, including its US branch, generally can use substituted compliance when facing a domestic covered counterparty[9] or, if the rules apply, a foreign covered counterparty.
  - Under the rules published by the prudential regulators, if a foreign regulated entity is a subsidiary of a US entity, then substituted compliance is only available if it is either a subsidiary of a depository institution, an Edge corporation or an agreement corporation[10], or is a foreign bank acting through a US branch or agency.
  - Substituted compliance is not available under the rules of either the prudential regulators or the CFTC if the regulated entity is guaranteed by a US entity[11]. It is also not available under CFTC rules for a foreign regulated entity with a principal place of business in the US.

Use of substituted compliance requires a determination by the CFTC or a joint determination by the prudential regulators that the relevant foreign jurisdiction's margin requirements are comparable to their own. A substituted compliance determination may be subject to additional conditions. If substituted compliance is available, a regulated entity can use it by complying with foreign regulations[12] instead of the requirements of the prudential regulators or the CFTC.

Cross-border Application – SEC Rules

The SEC rules apply to all in-scope trades of a regulated entity with a covered counterparty, regardless of the location of the regulated entity or the counterparty. But the SEC's segregation rules relating to margin for security based swaps only apply to a foreign regulated entity if it is trading with a US entity or is a foreign bank acting through a US branch.

Substituted Compliance – SEC Rules

- Under the SEC rules, a regulated entity organized in the US or that has a principal place of business in the US cannot use substituted compliance.

[7] Under the CFTC rules, this would not include a foreign entity with a principal place of business in the US, and therefore is not available to a domestic regulated entity facing a foreign investment fund managed from the US

[8] Under the rules published by the prudential regulators, this limited substituted compliance for IM posting will also not be available if the covered counterparty is guaranteed by the US branch of a foreign bank. Under CFTC rules, it will also not be available if the foreign covered counterparty is guaranteed by a foreign entity with a principal place of business in the US

[9] Under the CFTC rules, if the covered counterparty is also a regulated entity subject to CFTC rules and is a US entity or guaranteed by a US entity, then substituted compliance is limited to collection of initial margin

[10] Note that under the cross-border rules published by the prudential regulators, a foreign regulated entity that is a subsidiary of *any* US entity must apply US rules when trading with foreign covered counterparties

[11] Under the rules published by the prudential regulators, a guarantee from a US branch of a foreign bank does not prevent a foreign regulated entity from using substituted compliance

[12] The CFTC cross-border rule explicitly adds a requirement that the regulated entity be 'subject to' the foreign regulations

- A foreign regulated entity can use substituted compliance by complying with foreign regulations.
  - Substituted compliance is not available for the segregation requirements but, as noted above, they apply only to a limited extent to a foreign regulated entity;
  - Guarantors, branches and subsidiary status are not relevant to the availability of SEC substituted compliance.

Use of substituted compliance requires a determination by the SEC that the relevant foreign jurisdiction's margin requirements are comparable to its own. The SEC cannot make a substituted compliance determination unless it has entered into a supervisory and/or other arrangement with the relevant foreign financial regulatory authority addressing supervisory and enforcement cooperation and other matters arising under the substituted compliance determination. A substituted compliance determination may be subject to additional conditions.

Covered Counterparty Determinations Where Substituted Compliance is Unavailable

If Party A is a regulated entity under the US rules and its trading relationship with Party B is not excluded under the cross-border rules, and full substituted compliance is not available or a relevant comparability determination has not been made, then:

- If the rules published by the prudential regulators or the CFTC apply to Party A, Party B will be a covered counterparty if it would fall within one of the several categories of 'financial end user' were it a US entity (and would not meet one of the exceptions); and
- If the SEC regulations apply to Party A, Party B will be a covered counterparty unless it fits within one of the exceptions in the rule.

EU and Japan

The EU and Japan margin regimes are similar in that regulated entities are generally limited to entities organized or established in the jurisdiction, although with some exceptions.

- An alternative investment fund (AIF) established outside the EU and managed by an EU alternative investment fund manager (AIFM) authorized or registered in accordance with the Alternative Investment Fund Managers Directive (AIFMD) is a regulated entity for the EU rules. This is subject to some very limited exceptions for AIFs that are set up exclusively for the purpose of serving employee share purchase plans or acting as securitization special purpose entities.
- A Japan branch of a foreign country entity that is registered in Japan as a financial instruments business operator (FIBO) and a Japan branch of a foreign bank or foreign insurance company that is registered in Japan as a registered financial institution (RFI) is a regulated entity for the Japan rules.

The EU and Japan rules apply to domestic regulated entities (and to this limited scope of foreign regulated entities) when facing any covered counterparty, regardless of location.

Cross-border Application

Because the EU and Japan rules generally apply only if one party to the relationship is a domestic regulated entity, the cross-border application of EU and Japan rules is mostly limited to a domestic regulated entity facing a foreign covered counterparty. However, the exceptions noted above mean that, in some cases, the rules can apply when a foreign regulated entity faces a foreign covered counterparty.

The EU cross-border rules expand the scope of application to additional scenarios when two foreign entities face one another:

- A party to the contract is guaranteed by an EU entity that is a financial counterparty (FC) and certain additional criteria are met.
- Both parties are acting through an EU branch and would be FCs if they were established in the EU.

Strictly speaking, there are no similar provisions under the Japan rules. (For the avoidance of doubt, transactions between a foreign bank's Japan branch registered as an RFI and another foreign bank's Japan branch registered as an RFI are subject to the Japan rules, as both parties are regulated in Japan.)

Substituted Compliance

Under EU rules, substituted compliance may allow a regulated entity to comply with an alternative applicable margin regime that has been determined equivalent, but only where at least one of the parties is established in the jurisdiction of that margin regime[13].

Under the EU rules, use of substituted compliance requires an implementing act by the EC declaring that the legal, supervisory and enforcement arrangements of the relevant third country are equivalent to the EU margin requirements, and ensure protection of professional secrecy that is equivalent to that set out in the European Market Infrastructure Regulation (EMIR). The requirements also need to be applied and enforced in an equitable and non-distortive manner to ensure effective supervision and enforcement in that third country.

Under the Japan rules, substituted compliance is available provided the transaction is subject to both the Japan rules and foreign regulations applicable to either party. Compared to the EU rules, there is no requirement that one of the entities must be established in the relevant foreign jurisdiction, but this does require the specific transaction to be in scope of both Japanese and foreign regulations.

Under the Japan rules, use of substituted compliance for a transaction that would also have to comply with the margin regime of a foreign state requires a finding by the commissioner of the JFSA that an exemption from the JFSA's margin rules is unlikely to be contrary to the public interest. A FIBO or RFI's compliance with the margin regime of the foreign state that is recognized by the JFSA also must not hinder protection of investors.

Covered Counterparty Determinations Where Substituted Compliance Not Available

In the event that substituted compliance is not available or a relevant substituted compliance determination has not been made:

- If a foreign entity (Party B) faces a regulated entity under the EU margin regime, then it will be a covered counterparty assuming it would be categorized as an FC if it were established in the EU or if it exceeds the EU clearing threshold test (and does not fall within an exception to the margin requirements).
- If Party B faces a regulated entity under the Japan margin regime, then it will be a covered counterparty if it enters into non-centrally cleared over-the-counter (OTC) derivatives 'as a business', it is in a foreign jurisdiction where the legal validity of close-out netting is appropriately confirmed, and it exceeds the *de minimis* swap activity level for variation margin.

[13] One important practical consequence of this rule is that EU substituted compliance with US rules will not be available for an EU regulated entity facing a US-registered swap dealer or security based swap dealer that is not established in the US

Money Market Funds in the US and EU – Threading the Cross-border Needle

ISDA and a number of other trade associations recently submitted requests to US and European regulators asking for relief from the cross-border application of rules on money market funds (MMFs) as eligible collateral.

- Under the rules published by prudential regulators and the CFTC, MMFs meeting certain conditions can be posted as eligible collateral. One condition is that the MMF's assets are limited, so the MMF may not use repos or similar transactions (US MMF).

- Under the EU rules, MMFs meeting certain conditions can be posted as eligible collateral. One condition is that the MMF is an EU fund authorized as a UCITS (EU MMF). EU MMFs are also subject to regulations that oblige them to meet diversification and liquidity requirements, which in practice mean they will typically be able to use repos.

Result: EU MMFs will not be eligible collateral under the margin regimes of US prudential regulators and the CFTC due to their permitted use of repos, and US MMFs are not eligible collateral under the EU margin regime, because they are not EU-authorized UCITS. **Where the rules of the CFTC or prudential regulators and those of the EU apply to a trading relationship, the parties cannot post MMFs as eligible collateral, despite all three sets of rules permitting the use of MMFs.**

Can Substituted Compliance/Equivalence Help?

While there have been comparability/equivalence determinations by the CFTC and EC of each other's rules, the US prudential regulators have not made any determinations, and there are limits to the substituted compliance/equivalence relief between the CFTC and the EU rules.

- CFTC substituted compliance is generally fully available for use by a non-guaranteed foreign regulated entity, but it is limited to IM posting for a domestic regulated entity.

- EU equivalence is only available where one of the parties is established in the US, and the EU equivalence determination adds that one of the parties must be a regulated entity under the CFTC rules and established in the US.

- The EU equivalence determination only applies to transactions that are both OTC derivatives under EU rules and swaps under US rules, and does not specify how this applies to collateral posted for a portfolio that contains derivatives that are not swaps.

As a result, even though the CFTC and EU regimes have been determined to be comparable/equivalent, there remain significant restrictions on MMFs the parties can post. For example:

- Where an EU fund that is a financial counterparty faces a US CFTC-regulated swap dealer, the parties may post US MMFs but not EU MMFs. However, it is not clear how that works where the portfolio contains derivatives that are not swaps.

- Where the EU fund faces a non-US CFTC-regulated swap dealer that is a subsidiary of a US parent, the parties may post EU MMFs but not US MMFs.

- Where a US fund that is a financial end user faces an EU dealer that is a CFTC-regulated swap dealer, the parties may post EU MMFs but not US MMFs.

Substituted compliance between the rules published by US prudential regulators and the EU is not available, because neither the prudential regulators nor the EC have made a comparability or equivalence determination of the other's rules as of the date of this guide.

APPENDIX

Charts of Cross-border Application and Availability of Substituted Compliance Under US, EU and Japan Rules

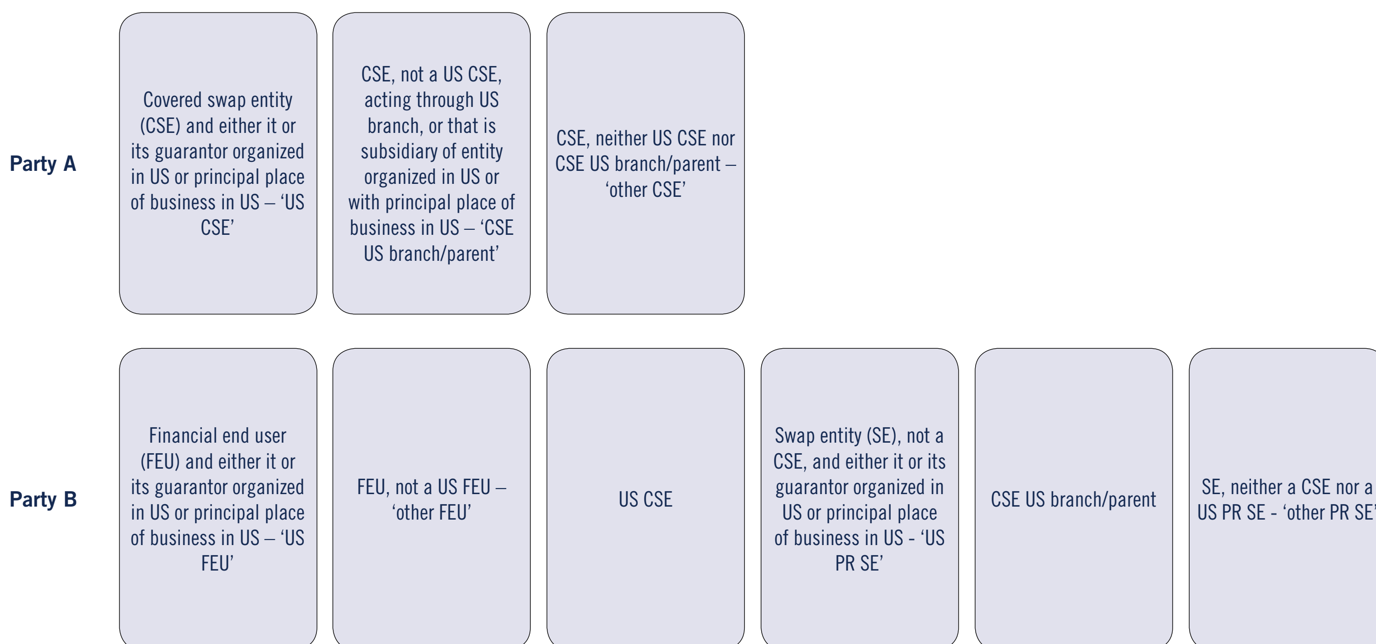
These tables set out the circumstances in which substituted compliance will be available after a foreign margin regime has been determined comparable or equivalent. Substituted compliance being 'available' means the parties can benefit from a comparability or equivalence determination, based on the rules of the margin regime and assuming no additional conditions are imposed in the comparability/equivalence determination. In practice, a specific comparability/equivalence determination may impose additional requirements not reflected here.

The approach is to look at the analysis from the point of view of a regulated entity under the domestic rules (Party A). It identifies the different types of regulated entity that are relevant for the substituted compliance analysis, and the different types of covered counterparties it might face (Party B). It then identifies and groups the regulated entities and covered counterparties based on their location or other information relevant to substituted compliance, and sets out in a table the availability of substituted compliance for the different combinations of regulated entity and covered counterparty. The status of any entity that is neither a regulated entity nor a covered counterparty is not considered.

All actions of a branch of an entity are treated as actions of that entity, unless otherwise noted.

The charts rely to some extent on regulatory terms from the different margin regimes to identify regulated entities and covered counterparties. These terms are explained for each regime in the glossary at the end.

CFTC Rules[14]



Party A	Party B	Application of Rules and Party A's Potential for Substituted Compliance
US CSE[15]	US FEU, US CSE, US PR SE[16], CSE US branch/parent, other PR SE	CFTC rules apply, no substituted compliance[17]
US CSE	Other FEU	CFTC rules apply, substituted compliance available only for posting IM, provided Party B is subject to foreign jurisdiction's regulatory requirements
CSE US branch/ parent, other CSE	US FEU, US PR SE, CSE US branch/parent	CFTC rules apply, full substituted compliance available, provided Party A is subject to foreign jurisdiction's regulatory requirements
CSE US branch/ parent, other CSE	US CSE	CFTC rules apply, substituted compliance available only for collecting IM[19], provided Party A is subject to foreign jurisdiction's regulatory requirements
CSE US branch/ parent	Other FEU, other PR SE	CFTC rules apply, full substituted compliance available, provided Party A is subject to foreign jurisdiction's regulatory requirements
Other CSE	Other FEU, other PR SE[18]	Excluded from CFTC rules, provided that if relevant swap is not covered by a comparability determination and Party A transfers the risk to a margin affiliate that is a US CSE, the CFTC rules apply

[14] These rules would also apply to security based swaps of a security based swap dealer that is subject to the SEC rules, but is entitled to and does elect to apply the alternative compliance mechanism to apply the CFTC rules on capital, margin and segregation to security based swaps in lieu of the SEC rules under §240.18a-10

[15] Note that the term 'US CSE' used here (unlike the definition of 'U.S. CSE' used in the text of the CFTC cross-border rule itself) includes a foreign CSE guaranteed by a US entity

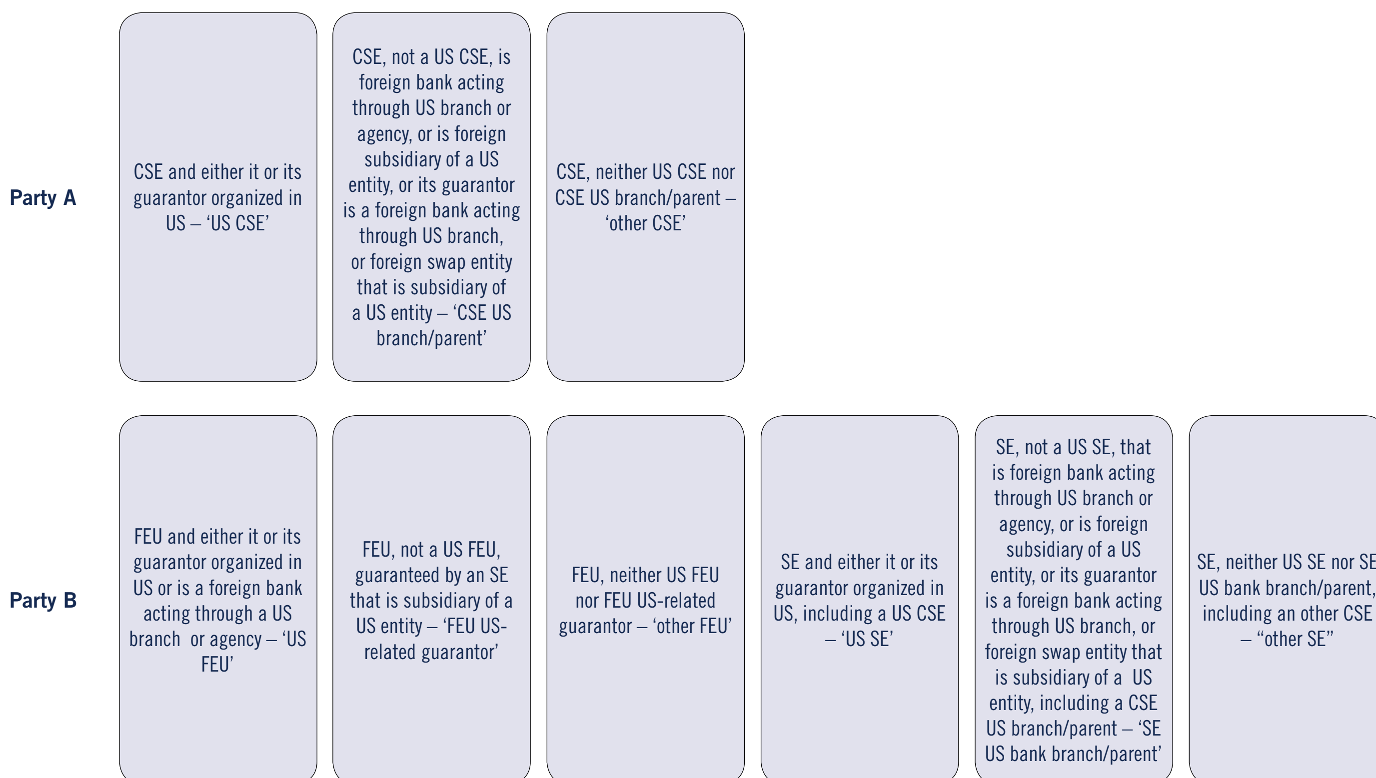
[16] A 'swap entity' under the CFTC rules includes a swap dealer that has a prudential regulator, but does not include a security based swap dealer unless it is also registered as a swap dealer (regardless of whether it has a prudential regulator)

[17] A limited substituted compliance for IM posting might theoretically be available where Party B is a CSE US branch/parent or other PR SE, but there is no obligation to post IM to another swap entity

[18] Note that 'other PR SE' could include a US branch of a swap entity or a swap entity that is a subsidiary of a US entity. This implies different cross-border treatment where Party A is an 'other CSE' and Party B is a foreign swap entity acting through a US branch or is a subsidiary of a US entity, depending on whether Party B has a prudential regulator (and is therefore an 'other PR SE') or not (and is therefore a 'CSE US branch/parent')

[19] There is no obligation to post IM to another swap entity

US Prudential Regulators' Rules



Party A	Party B	Application of Rules and Potential for Substituted Compliance
US CSE	US FEU, US SE, SE US bank branch/parent, other SE[20]	Prudential regulators' rules apply, no substituted compliance[21]
US CSE	FEU US-related guarantor, Other FEU	Prudential regulators' rules apply, substituted compliance available only for posting IM, provided Party B is subject to foreign rules
CSE US branch/ parent	US FEU, FEU US-related guarantor, other FEU, US SE, SE US bank branch/parent, other SE	Prudential regulators' rules apply. Full substituted compliance may be available to allow Party A to comply with foreign rules, but only if Party A is a foreign bank acting through a US branch or is a subsidiary of a US depository institution, Edge corporation or agreement corporation[22]
Other CSE	US FEU, FEU US-related guarantor, US SE, SE US bank branch/parent	Prudential regulators' rules apply, full substituted compliance available to allow Party A to comply with foreign rules[23]
Other CSE	Other FEU, other SE	Excluded from prudential regulators' obligations

[20] A 'swap entity' under the rules published by the prudential regulators includes any swap dealer or security based swap dealer

[21] A limited substituted compliance for IM posting might theoretically be available in some cases where Party B is an SE US bank branch/parent or other SE, but there is no obligation to post IM to another swap entity

[22] The definition of 'foreign covered swap entity' in S_.9(c)(3) excludes a swap entity that is 'a subsidiary of an entity that is organized under the laws of the United States or any State', so the exception for foreign swaps of a foreign covered swap entity is not available to such an entity. However, the corresponding limb of the test that defines availability of substituted compliance in S_.9(d)(3)(ii)(C) is limited to 'an entity that is a subsidiary of a depository institution, Edge corporation, or agreement corporation'

[23] If Party A is required to post IM, it may also be able to satisfy its IM posting obligation by posting the amount Party B is required to collect under a different set of foreign rules, provided Party B is subject to those rules (and regardless of whether Party A is required to comply with them). This is not available if Party B is a US FEU

SEC Rules[24]

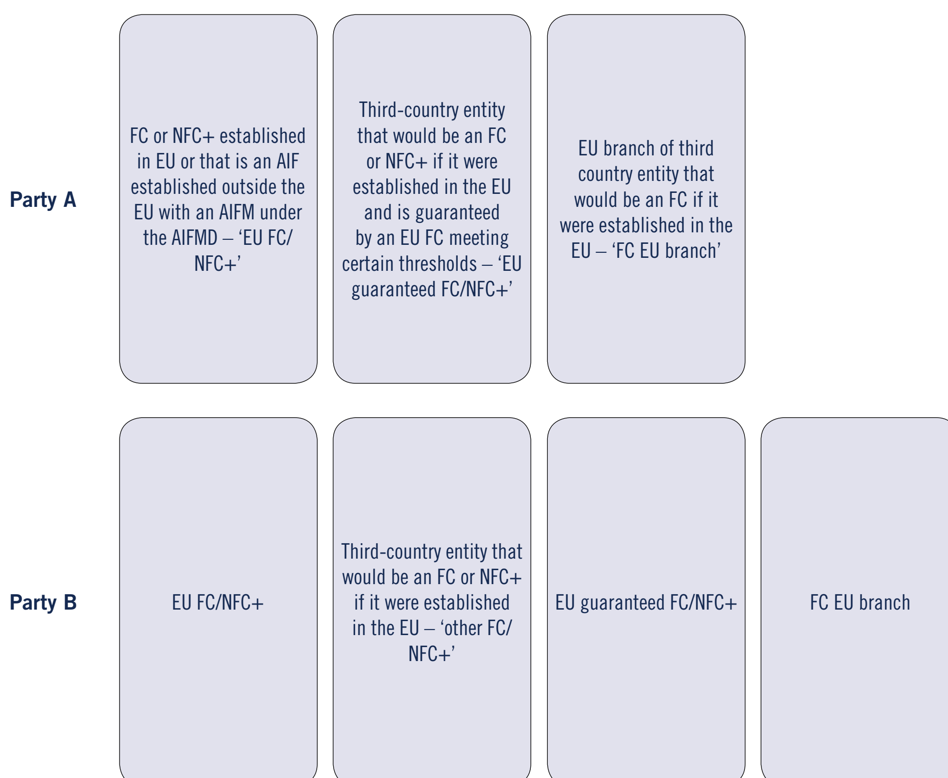
Party A	Party B	Application of Rules and Potential for Substituted Compliance
US SBSD[25]	US non-exempt CP, other non-exempt CP	SEC rules apply, no substituted compliance
Foreign bank SBSD US branch, foreign bank SBSD non-US branch, other SBSD	US non-exempt CP	SEC rules apply, substituted compliance available for Party A to comply with foreign rules, but not available for segregation and disclosure requirements
Foreign bank SBSD US branch	Other non-exempt CP	SEC rules apply, substituted compliance available for Party A to comply with foreign rules, but not available for segregation and disclosure requirements[26]
Foreign bank SBSD non-US branch, other SBSD	Other non-exempt CP	SEC rules apply except for segregation and disclosure requirements, substituted compliance available for Party A to comply with foreign rules

[24] If a security based swap dealer that is subject to the SEC rules is entitled to and has elected to apply the alternative compliance mechanism to apply the CFTC rules on capital, margin and segregation to security based swaps in lieu of the SEC rules under §240.18a-10, please see the CFTC table above

[25] The SEC rules, unlike the rules published by the CFTC and prudential regulators, do not contain a defined term including both security based swap dealers and major security based swap participants, and the rules applicable to major security based swap participants are different in some respects. These tables focus only on the position of a security based swap dealer. The SEC margin requirements apply only to a security based swap dealer that does not have a prudential regulator, except that the segregation and disclosure rules apply to any security based swap dealer, unless operating under the general exemption provided

[26] This table is limited to entities that are not exempt from the IM requirements. However, the SEC segregation and disclosure rules do not contain the same counterparty exemptions, so could potentially apply to counterparties that are not subject to the IM requirements

EU Rules



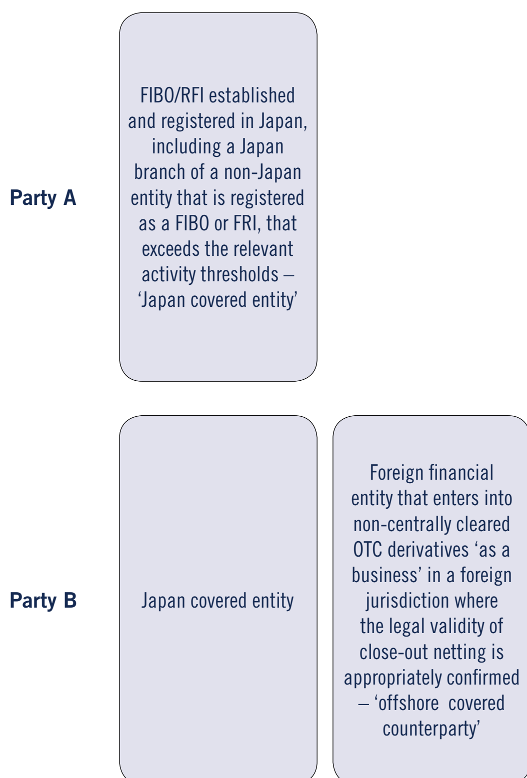
Party A	Party B	Application of Rules and Potential for Substituted Compliance
EU FC/NFC+[27]	EU FC/NFC+	EU rules apply, substituted compliance is generally unavailable, except that if at least one of the parties is an AIF established in a third country, substituted compliance is available for that country's rules[28]
EU FC/NFC+	Other FC/NFC+, EU guaranteed FC/NFC+, FC EU branch	EU rules apply, substituted compliance available provided at least one of Party A and Party B is established in the relevant country[28]
EU guaranteed FC/NFC+	EU FC/NFC+, other FC/NFC+, EU guaranteed FC/NFC+, FC EU branch	EU rules apply, substituted compliance available provided at least one of Party A and Party B is established in the relevant country[28]
FC EU branch [29]	FC EU branch	EU rules apply, substituted compliance available provided at least one of Party A and Party B is established in the relevant country[28]
FC EU branch	EU FC/NFC+, other FC/NFC+, EU guaranteed FC/NFC+	EU rules do not apply to Party A (but note that they will apply to Party B when facing Party A in this scenario, with substituted compliance available provided at least one of Party A and Party B is established in the relevant country)[28]

[27] An alternative investment fund established outside the EU and managed by an EU AIFM authorized or registered in accordance with the AIFMD (Directive 2011/61/EU) is a financial counterparty under EMIR (unless it falls within an exception). Such an entity would therefore be an 'EU FC/NFC+', not an 'Other FC/NFC+'

[28] While the general approach in this Appendix is to assume that no additional conditions are imposed in a comparability/equivalence determination, it is worth noting that the two EU equivalence determinations made to date (for the US CFTC rules and the Japan rules) require that at least one of the counterparties is not only established in the relevant foreign country, but is also registered with the relevant foreign regulator and is subject to the relevant foreign margin regime. So, for example, if Party A is established in the EU and Party B is established in the US or Japan but is not registered as required or is not subject to the relevant margin regime, then substituted compliance will not be available. See the discussion above relating to money market funds for some of the implications of this requirement

[29] Note that an FC EU branch is only treated as a regulated entity directly subject to the EU rules when transacting with another FC EU branch

Japan Rules



Party A	Party B	Application of Rules and Potential for Substituted Compliance
Japan covered entity	Japan covered entity, offshore covered counterparty	Japan rules apply, substituted compliance available, provided the transaction is subject to foreign regulations applicable to either party

GLOSSARY OF MARGIN REGIME TERMS

US Rules (CFTC, Prudential Regulators and SEC)

CSE: Covered swap entity. This is defined in the CFTC rules as a swap dealer (SD) or major swap participant (MSP) registered with the CFTC for which there is no prudential regulator (therefore subject to CFTC margin rules). It is defined in the rules published by prudential regulators as an SD, MSP, security based swap dealer (SBSD) or major security based swap participant (MSBSP) registered with the CFTC or SEC as applicable that is a type of entity subject to the jurisdiction of a prudential regulator (separately defined for each prudential regulator).

FEU: Financial end user. This is defined in the rules published by the CFTC and prudential regulators by reference to a range of regulated financial entity types under US law, and also includes an entity that would be a financial end user if it were organized under the laws of the US or any US state. Note that the rules published by the CFTC and prudential regulators provide for different treatment of SBSDs and MSBSPs. Under the CFTC rules, SBSDs and MSBSPs are financial end users, while SDs and MSPs are 'swap entities'. Under the rules published by prudential regulators, SBSDs and MSBSPs (as well as SDs and MSPs) are excluded from the definition of financial end user as 'swap entities'.[30]

SBSD: Security based swap dealer.

SE: Swap entity. This is defined differently in the rules published by the CFTC and prudential regulators. Under the CFTC rules, this is defined as a person registered with the CFTC as an SD or MSP. Under the rules published by prudential regulators, this is defined as a person registered either with the CFTC as an SD or MSP, or with the SEC as an SBSD or MSBSP.

EU Rules

AIF: Alternative investment fund.

AIFMD: Alternative Investment Fund Managers Directive (Directive 2011/61/EU). AIFM means an alternative investment fund manager authorized or registered in accordance with the AIFMD.

FC: Financial counterparty established in the EU, defined by reference to a range of regulated financial entity types under EU law. An FC does not include an entity established outside the EU, other than an AIF established outside the EU and managed by an AIFM authorized or registered in accordance with the AIFMD, which is currently limited to an EU AIFM.

NFC+: Non-financial counterparty established in the EU that exceeds the clearing threshold.

Japan Rules

FIBO/RFI: Financial instruments business operators (FIBOs), banks that are registered financial institutions (RFIs), insurance companies that are RFIs and trust accounts that are either FIBOs or RFIs, as well as Shoko Chukin Bank, Development Bank of Japan, Shinkin Central Bank and the Norinchukin Bank.

[30] The main consequence of this difference is that under both rule sets, when facing a swap entity, a covered swap dealer must collect IM regardless of the swap entity's AANA, but does not need to post IM. When facing a financial end user, there is only an IM obligation if the financial end user has material swaps exposure, and the obligation is to post and collect IM. There are also small differences in the cross-border application of the rules, noted in the charts

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