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U.S. Banking Regulators Finalize Minimum Margin Requirements for Uncleared Swaps

On October 22, 2015, the Federal Deposit Insurance Corporation (the “FDIC”) and the Office of the Comptroller of the Currency (the “OCC”) adopted final rules (the “Final Margin Rules”)¹ establishing minimum margin and capital requirements for uncleared swaps and uncleared security-based swaps (together, “uncleared swaps”). The Final Margin Rules, which are to be jointly adopted by the other U.S. federal banking regulators² (together, the “Prudential Regulators”), set margin requirements for uncleared swaps executed by registered swap dealers, major swap participants, security-based swap dealers and major security-based swap participants for which there is a Prudential Regulator (collectively, “swap entities”).³

While the Final Margin Rules do not apply directly to buy-side entities, they will have a material impact on buy-side entities who use uncleared derivatives. They will impose minimum margin requirements on derivatives transactions between buy-side entities and swap entities and may increase the amount of margin buy-side entities are required to provide. They will impose regulatory requirements on the timing of transferring margin, which will accelerate the current margin process for many buy-side entities. They will also effectively require changes to typical derivatives margin documentation, including the ISDA Credit Support Annex.

The Final Margin Rules are largely consistent with the rules re-proposed by the Prudential Regulators (the “Proposed Rules”) and the Commodity Futures Trading Commission in September 2014, as well as the final framework for margin requirements for uncleared swaps that the Basel Committee on Banking Supervision and the International Organization of Securities Commissions adopted in September 2013 (the “Basel/IOSCO Framework”). Set forth below are the highlights of the Final Margin Rules, including aspects that are different from the Proposed Rules and the Basel/IOSCO Framework. Ropes & Gray’s previous Client Alert regarding the Proposed Rules can be found [here](#).

Who will be required to exchange variation margin?

Like the Proposed Rules, the Final Margin Rules require a swap entity to collect and post *variation margin* for uncleared swaps with counterparties who are swap dealers, major swap participants, security-based swap dealers, major security-based swap participants or “financial end users.” The requirements will apply to all of a swap entity’s swap and security-based swap activities without regard to whether the entity has registered as both a swap dealer/major swap participant and a security-based swap dealer/major security-based swap participant. Deliverable foreign exchange swaps and deliverable foreign exchange forwards, which are excluded from the definition of “swap” pursuant to a determination of the Secretary of the Treasury, are not subject to the Final Margin Rules.

The proposed definition of “financial end user” generally included, among others, investment advisers, registered investment companies, private funds (as defined in Section 202(a) of the Investment Advisers Act of 1940), commodity pools, commodity pool operators, commodity trading advisers, and any entity that would be a financial end user or a swap entity if it were organized under the laws of the United States or any state thereof. The Final

¹The [Prudential Regulators’ Final Margin Rules](#) have been posted on the FDIC’s website, but have not yet been published in the Federal Register.

²The applicable federal banking regulators are the OCC, the Board of Governors of the Federal Reserve System, the FDIC, the Farm Credit Administration and the Federal Housing Finance Agency.

³Among others, this includes U.S. banks, foreign banks, bank holding companies and subsidiaries of bank holding companies or foreign banks.

Margin Rules expand this definition to include a new prong: “an entity, person, or arrangement that is, or holds itself out as being, an entity, person or arrangement that raises money from investors, accepts money from clients, or uses its own money primarily for the purpose of investing or trading or facilitating the investing or trading in loans, securities, swaps, funds, or other assets for resale or other disposition or otherwise trading in loans, securities, swaps, funds, or other assets.” This expansion creates unwelcome uncertainty for certain buy-side entities who do not perform investment management services but invest their own money as to whether they will be “financial end users.”

Who will be required to exchange initial margin?

The Final Margin Rules also require a swap entity to collect and post initial margin for uncleared swaps with counterparties that are swap dealers, major swap participants, security-based swap dealers, major security-based swap participants or “financial end users with material swaps exposure.”

In the Final Margin Rules, the Prudential Regulators have increased the “material swaps exposure” threshold, subjecting transactions by fewer entities to the initial margin requirements. A financial end user has “material swaps exposure” if it has an average daily aggregate notional amount of over-the-counter derivatives of \$8 billion (measured over June, July and August of the previous year). This revised threshold is closer to the threshold in the Basel/IOSCO Framework (which provides for an €8 billion threshold) than the \$3 billion threshold under the Proposed Rules.⁴

In determining whether a financial end user has material swaps exposure, the financial end user has to include not only over-the-counter derivatives of such financial end user, but also over-the-counter derivatives of its affiliates. Under the Final Margin Rules, “affiliates” are now defined as entities consolidated (or that would be consolidated) for purposes of preparing financial statements under generally accepted accounting standards, and any entity that the relevant Prudential Regulator has determined is an affiliate of another company, based on the Prudential Regulator’s conclusion that either company “provides significant support to, or is materially subject to the risks or losses of, the other company.” This approach represents a narrowing of the Proposed Rules, which defined an “affiliate” as any company that controls, is controlled by, or is under common control with another company (in general, defining “control” as a 25% voting or equity interest), and makes it less likely that different funds managed by an investment adviser would need to be aggregated for purposes of this threshold.

The Final Margin Rules also provide clarity on how the margin requirements apply in the event a financial end user’s status changes because it moves above or below the threshold. If a financial end user enters into a transaction when it is below the material swaps exposure threshold, but later exceeds the threshold, initial margin generally would only be required for transactions entered into after it crossed the threshold (unless the old and new swaps are part of the same “netting set,” as described in more detail below). However, if a financial end user is above the material swaps exposure threshold when it enters into an uncleared swap, but later falls below the threshold, initial margin that had been previously collected by the swap entity counterparty could be returned if agreed by both parties, and any new uncleared swaps entered into between the parties will not be subject to the initial margin requirement. As described below, parties may enter into multiple “netting sets,” among other reasons, to separate application of the margin rules to uncleared swaps entered into before and after a financial end user’s change in status.

Posting and Collecting Variation and Initial Margin

Initial margin and variation margin must be posted and collected on a daily basis for a period beginning on or before the business day after the “day of execution”⁵ of an uncleared swap and ending on the date the uncleared swap is

⁴While they are not subject to the mandatory margin requirements, deliverable foreign exchange swaps and deliverable foreign exchange forwards must be included in the calculation of an entity’s swaps exposure for this purpose.

⁵The Final Margin Rules include provisions to help market participants determine the “day of execution” when the counterparties to a transaction are located in jurisdictions across different time zones. If at the time parties enter into the swap, it is a different calendar day at the location of each party, the day of execution is deemed to be the latter of the two calendar days. If a non-cleared swap is entered into between 4 p.m. and midnight in the location of a party, then such swap shall be deemed to

terminated or expires. This timing is shorter than what is typically included in many market participants' current collateral arrangements, such as those governed by the ISDA Credit Support Annex. Commenters had objected to this proposed timing, noting, among other things, that the settlement and delivery periods for many types of eligible margin securities are longer than the time allowed for margin collection under the Final Margin Rules. In response to these comments, the Prudential Regulators noted that, in complying with this requirement, swap entities and their counterparties may be required to take steps such as "pre-positioning" eligible margin collateral securities at the custodian or initially supplying cash and subsequently arranging to substitute other eligible margin collateral securities after the initial margin collateral in the form of cash has been delivered to the custodian and the minimum margin requirements have been satisfied. This requirement may give rise to changes to market participants' collateral management processes.

The Prudential Regulators adjusted the dollar-denominated thresholds in the Final Margin Rules to more closely align with the thresholds under the Basel/IOSCO Framework and the anticipated margin requirements in the European Union. As such, parties are not required to post or collect initial or variation margin unless and until the required cumulative amount of initial and variation margin is greater than \$500,000 (down from \$650,000). Initial margin payments will be subject to a revised maximum threshold amount of \$50 million (down from \$65 million), calculated as the aggregate credit exposure resulting from all uncleared swaps and security-based swaps between a swap entity and its affiliates and the counterparty and its affiliates.⁶ The minimum transfer amount and threshold specified in the Final Margin Rules are maximum amounts; the parties are free to adopt a lower minimum transfer amount or threshold for either or both parties.

For purposes of the Final Margin Rules, aggregate credit exposure in the context of separate accounts with multiple managers must be aggregated across managers (measured at the fund or entity level as opposed to the account level). Among other things, this means that the minimum transfer amount and any threshold would be calculated at the fund or entity level, not the account level. This could result in significant operational issues for funds or other entities that employ multiple investment managers.

Eligible Collateral

The types of eligible collateral that may be exchanged have been expanded in the Final Margin Rules. For example, under the Proposed Rules, variation margin was limited to cash in the form of U.S. dollars or the currency in which payment obligations under the swap are required to be settled. Under the Final Margin Rules, eligible collateral for initial and variation margin (other than for certain inter-dealer swaps) includes cash, U.S. Treasury securities, certain U.S. government agency securities, certain publicly traded debt securities, certain publicly traded common equity securities, certain redeemable government money market funds⁷ and gold. Any cash margin must be either U.S. dollars, another "major currency"⁸ or the currency of settlement for the uncleared swap. Non-cash collateral is subject to certain minimum haircuts included in the Final Margin Rules. An additional 8% haircut will apply to margin that is denominated in a currency other than the currency of settlement, except that cash in any "major currency" is not subject to a haircut. Also, non-cash initial margin is not subject to a haircut if it is denominated in a

have been entered into on the immediately succeeding day that is a business day for both parties. If the foregoing results in a day that is not a business day for one of the parties, then the day that is the next business day for both parties will be used for this purpose.

⁶The threshold amount applies on a consolidated basis, and applies both to the consolidated swap entity as well as to the consolidated counterparty.

⁷Money market fund securities were not included as eligible collateral in the Proposed Rules. The Final Margin Rules release includes guidance regarding acceptable types of money market funds. Among the requirements are that the assets of the money market fund may not be "transferred" through securities lending, repurchase agreements/reverse repurchase agreements or "other means that involve the fund having rights to acquire the same or similar assets from the transferee."

⁸The Final Margin Rules define "major currency" as (i) United States Dollar (USD); (ii) Canadian Dollar (CAD); (iii) Euro (EUR); (iv) United Kingdom Pound (GBP); (v) Japanese Yen (JPY); (vi) Swiss Franc (CHF); (vii) New Zealand Dollar (NZD); (viii) Australian Dollar (AUD); (ix) Swedish Kronor (SEK); (x) Danish Kroner (DKK); (xi) Norwegian Krone (NOK); or (xii) any other currency as determined by the relevant agency.

single termination currency designated as payable to the non-posting party under the applicable governing documentation. The Final Margin Rules release notes that if a party has the option to select the termination currency or to select from among more than one termination currency as part of the governing documentation, the agreement would not meet the single termination currency condition in the Final Margin Rules. Going forward, market participants may wish to confirm that their ISDA Master Agreements specify a single termination currency, rather than allowing a party to select a termination currency, so that this exception from the 8% haircut will be available.

Mandatory Segregation of Initial Margin

The Final Margin Rules impose certain collateral safekeeping requirements on initial margin that is posted or collected by a swap entity. These requirements generally are consistent with the requirements under the Proposed Rules. Initial margin that is *posted* by a swap entity to a counterparty (whether or not such amount of initial margin is required by the Final Margin Rules, is in excess of the required amount, or is posted to a counterparty to which the swap entity is not required by the Final Margin Rules to post such initial margin) must be held with a custodian that is not the swap entity, the counterparty, or an affiliate of the swap entity or counterparty (a “third-party custodian”). Initial margin that is *collected* by a swap entity (up to the amount required by the Final Margin Rules) must be held at a third-party custodian.

Such custodial arrangements must prohibit the custodian from rehypothecating, repledging, reusing or otherwise transferring the funds or property held by the third-party custodian. Cash collateral may be held in a general deposit account with the custodian only if the funds in the account are used to purchase eligible non-cash assets, such assets are segregated and such purchase takes place within a reasonable time period after the cash collateral is collected. Since mandatory minimum haircuts are imposed on non-cash margin, this could require posting of an additional cash margin so that there is sufficient margin after giving effect to the haircuts. The safekeeping requirements do not apply to variation margin.

Cross-Border Application

The Final Margin Rules do not apply to “foreign non-cleared swaps” of a foreign swap entity. The term “foreign” swap entity means any swap entity that is not (i) organized under U.S. or state law; (ii) a branch or office of an entity organized under U.S. or state law; or (iii) an entity that is a subsidiary of an entity organized under U.S. or state law. U.S. branches of a foreign bank and U.S. subsidiaries of foreign companies are not considered foreign and will be subject to the Final Margin Rules. The term “foreign non-cleared swaps” means any uncleared swap of a foreign swap entity to which neither the counterparty (nor guarantor on either side of the swap) is (i) an entity organized in the United States (including a U.S. branch, agency or subsidiary of a foreign bank or a natural person who is a resident of the United States); (ii) a branch or office of an entity organized in the United States; or (iii) a swap entity that is a subsidiary of an entity organized in the United States.

Practically speaking, this means that, for example, transactions between non-U.S. funds (including funds with U.S.-based asset managers) and non-U.S. dealers (that do not have a U.S. parent or U.S. guarantor) would not be subject to the Final Margin Rules. However, such transactions could be subject to the margin requirements of other jurisdictions (with no substituted compliance), which may be less favorable or inconsistent with rules applying to U.S. parties.

Eligible Master Netting Agreements and Documentation Requirements

The Final Margin Rules generally apply only to new uncleared swaps entered into after the Final Margin Rules become effective. Like the Proposed Rules, however, under the Final Margin Rules, margin may be calculated on a net basis including all uncleared swaps between the swap entity and the counterparty, but then all existing uncleared swaps between the parties (including those entered into prior to the effectiveness of the new margin requirements) must be included in the calculation pursuant to an eligible master netting agreement. If the parties do not wish for the new margin requirements to apply to trades in existence prior to the relevant compliance date pursuant to such a netting arrangement, the Prudential Regulators note that the parties may enter into a “netting set” for new uncleared

swaps that are subject to the Final Margin Rules and another “netting set” for existing uncleared swaps that are not subject to the Final Margin Rules. Both netting sets may be part of the same eligible master netting agreement.

Swap entities must execute trading documentation with each counterparty that is a swap dealer, major swap participant, security-based swap dealer, major security-based swap participant or a financial end user, which specifies the contractual rights and obligations of the swap entity to collect and post initial and variation margin in such amounts, form and under such circumstances as required by the Final Margin Rules. The documentation also must include provisions governing valuation of swaps for purposes of calculating variation margin requirements, provisions governing resolution of disputes and a description of the “methods, procedures, rules, and inputs” for calculation of initial margin. These documentation requirements will likely require changes to existing credit support agreements.

During the commenting process, buy-side market participants had raised concerns about the rules governing a swap entity’s obligation to collect or post margin, noting that, since the swap entity would determine margin requirements based on its models, the rules should allow for dispute resolution procedures acceptable to both parties. They noted that the rules could be interpreted by swap entities in a manner that would have the effect of prohibiting buy-side entities from withholding collateral payments while a dispute over margin is being resolved. The Final Margin Rules provide that the swap entity would not be deemed to have violated its obligation to collect or post initial or variation margin from (or to) a counterparty if the counterparty is acting in accordance with agreed-upon practices to settle a disputed trade.

Next Steps

The compliance dates for the Final Margin Rules have been revised to align with the compliance dates in the Basel/IOSCO Framework and the anticipated margin requirements in the European Union. The compliance date for the required exchange of variation margin is **September 1, 2016**, for uncleared swaps where both the swap entity (and its affiliates) and the 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 outstanding for March, April and May of 2016 that exceeds \$3 trillion. The compliance date for variation margin for any other swap entity with respect to covered uncleared swaps with any other counterparty is **March 1, 2017**.

Compliance with the initial margin rules will be phased in between September 1, 2016, and September 1, 2020, depending on the average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange forwards and foreign exchange swaps outstanding of the parties and their affiliates for March, April and May of that year: (i) if such amount for both parties for 2016 exceeds \$3 trillion, the compliance date is **September 1, 2016**; (ii) if such amount for both parties for 2017 exceeds \$2.25 trillion, the compliance date is **September 1, 2017**; (iii) if such amount for both parties for 2018 exceeds \$1.5 trillion, the compliance date is **September 1, 2018**; (iv) if such amount for both parties for 2019 exceeds \$0.75 trillion, the compliance date is **September 1, 2019**; and (v) otherwise, the compliance date is **September 1, 2020**.

It is expected that the CFTC will adopt Final Margin Rules establishing mandatory minimum margin requirements for swap dealers and major swap participants that are not subject to regulation by a Prudential Regulator later this year. The CFTC’s last set of proposed rules were substantially similar to the Proposed Rules. Additionally, the U.S. Securities and Exchange Commission (“SEC”) is developing rules establishing mandatory minimum margin requirements for security-based swap dealers and major security-based swap participants that are not subject to regulation by a Prudential Regulator. The SEC’s proposed rules differed in many respects from the Proposed Rules and the CFTC’s proposed rules, and it is not clear at this time if and when the SEC will re-propose its margin rules.

While the Final Margin Rules do not apply directly to buy-side market participants, as the compliance date for the Final Margin Rules approaches, buy-side market participants should begin to prepare for these sweeping changes to the swaps market. Market participants will need to put in place appropriate documentation to comply with the Final Margin Rules. This may include amendments to ISDA Credit Support Annexes (including, if the parties desire, documentation that provides for multiple “netting sets”) and triparty agreements governing segregated collateral. We

expect that some of these changes may be made through an industry protocol (which is not yet available). On the operational side, market participants also will need to be prepared to comply with the timing requirements for delivery of initial and variation margin within the time frames noted above, as well as other requirements. It is likely that buy-side market participants will be asked to provide representations to swap entities regarding their status as a “financial end user with material swaps exposure,” a “financial end user without material swaps exposure” or a non-financial end user.

Please contact the Ropes & Gray attorney who usually advises you with any questions.