financial reform matters

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Regulators Propose Minimum Margin Requirements for Uncleared Swaps

The Dodd-Frank Wall Street Reform and Consumer Protection Act requires banking regulators (including the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency, and the Board of Governors of the Federal Reserve System), on the one hand, and the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission, on the other hand, to set margin requirements for uncleared swaps and security-based swaps executed by bank and non-bank swap dealers, security-based swap dealers, major swap participants and major security-based swap participants.

Recent releases by the CFTC and by the FDIC on behalf of the banking regulators contain proposed minimum initial margin and variation margin requirements for uncleared swaps and security-based swaps. The two sets of proposed rules are similar but not identical.

The deadline for comments on the FDIC rules is June 24, 2011 and the comment deadline on the CFTC rules is 60 days after their publication in the Federal Register.

The big asymmetry

The not surprising, but still troubling, news is the asymmetry in the rules. Each set of rules proposes minimum margin requirements to be collected by swap dealers and major swap participants, but does not require any margin to be posted by such parties to their derivatives counterparties who are not swap dealers, security-based swap dealers, major swap participants, or major security-based swap participants. However, parties can still agree by contract that the dealer is required to provide collateral. In fact, in its release, the CFTC requests comment as to whether two-way variation margining should be required.

What trades are covered by the new margin rules?

The FDIC rules and the CFTC rules will apply to uncleared swaps and security-based swaps entered into on or after the effective date of the proposed rules. The effective date for the FDIC rules is 180 days after the publication of the FDIC rules as final rules. The CFTC is also expected to provide a transition period between publication of its final margin rules and the effective date of those rules.

How is margin calculated?

The proposed rules require the following amounts of minimum margin to be posted by financial entities to swap dealers, security-based swap dealers, major swap participants and major security-based swap participants:

> *Variation margin* will be required to be posted in an amount equal to the cumulative mark-to-market change in value of each swap from its trade date, subject only to a minimum transfer amount of $100,000 (which is lower than the minimum transfer amount currently specified in most ISDA Credit Support Annexes). The variation margin may be calculated on a net basis including all swaps and security-based

swaps between the swap dealer or major swap participant and the counterparty, but then all existing swaps and security-based swaps between the parties (including those entered into prior to the effectiveness of the new margin requirements) must be included in the calculation. Collection of variation margin must occur at least once per business day.

Initial margin will also be required. It will be determined either pursuant to (i) an initial margin model approved by the appropriate regulator or (ii) an alternative method set out in the rule. Under the CFTC rules, potential acceptable models include models approved by banking regulators, models used by derivatives clearing organizations, and vendor models. The FDIC rules seem to limit acceptable models to proprietary models of the bank dealer, whereas the CFTC rules do not allow the use of proprietary models. Under the FDIC rules, an initial margin model can account for either all uncleared swaps and security-based swaps entered into after the effective date of the rule or all uncleared swaps and security-based swaps regardless of their effective date. Although the CFTC rules for initial margin models do not cover this point, the release proposing the CFTC rules requests comment on whether swap dealers and major swap participants should be permitted voluntarily to include uncleared swaps entered into prior to the effective date of the rules in calculating margin under the rules.

The regulators also offer different alternative methods for calculating initial margin if a model is not employed. The alternative method in the FDIC rules is a table of initial margin requirements which, as listed in the proposed rules, vary from 0 to 2% of the notional amount for interest rate swaps with a duration of up to two years to 10 to 20% of the notional amount for commodity swaps, equity swaps, and certain other swaps. By contrast, under the alternative method described in the CFTC rules, a dealer can collect either two times the initial margin required by a clearinghouse for a comparable cleared swap or 4.4 times the initial margin required for a comparable cleared futures contract. Under both sets of rules the initial margin requirement may be subject to a minimum transfer amount of $100,000.

Citing an earlier proposed rule regarding documentation standards between dealers and their counterparties[1], the CFTC rules further require that the models used by non-bank dealers be specific enough to allow counterparties and regulators to perform margin calculations independently.

What collateral is eligible to be posted?

Both sets of proposed rules limit collateral eligible to be posted for uncleared swaps and security-based swaps to cash, U.S. Treasury securities (including STRIPS and inflation-indexed securities), and, in the case of initial margin only, agency securities. In valuing eligible collateral in the form of securities, dealers must apply discount haircuts set forth in the rule, based on remaining duration of the securities and the type and issuer of the security.

Finally, the CFTC rules require that dealers provide their financial counterparties with the option to have posted collateral held under a tri-party agreement with a custodian that is not affiliated with the dealer. These rules therefore provide more protection than other rules that have been previously proposed by the CFTC, which required that swap dealers offer their counterparties the option to have their initial margin held at a custodian, but allowed such custodian to be an affiliate of the swap dealer.[2]

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[1] Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, 76 FR 6715 (Feb. 8, 2011), available here.
[2] See Ropes & Gray Client Alert, Protecting Customer Margin for Cleared and Uncleared Swaps (November 30, 2010), available here.

What entities are exempt from the rules?

The proposed rules diverge slightly in providing an exemption from the margin rules for non-financial, commercial end-users. Under the FDIC rules, dealers are not required to collect margin for uncleared swaps and security-based swaps from non-financial, commercial end-users unless the dealer's exposure to that counterparty exceeds the dealer's internal credit limit for that counterparty. Under the CFTC rules, a dealer need not collect margin from commercial end-users until the dealer's exposure exceeds the threshold agreed upon in the credit support arrangement with the non-financial, commercial counterparty.

In addition, dealers are not required to collect margin from certain financial counterparties until pre-determined collateral thresholds are exceeded—a to-be-determined amount that will be the lesser of a fixed dollar amount (between $15 million and $45 million) or a fixed percentage of the dealer's regulatory capital (between 0.1 to 0.3 percent). Mutual funds and hedge funds will likely not qualify for this treatment, because it is available only to a financial entity which is subject to minimum capital requirements established by a banking regulator or state insurance regulator.

If you have questions about the proposed rules or their impact on your business, please contact Ropes & Gray Derivatives Practice co-heads Tim Diggins and Leigh Fraser, Deborah Monson, or your usual contact at the firm.