Regulators Re-Propose Minimum Margin Requirements for Uncleared Swaps

U.S. Federal banking regulators[1] (the "Prudential Regulators") recently re-proposed rules providing for minimum margin requirements for uncleared swaps and security-based swaps executed by swap dealers, security-based swap dealers, major swap participants and major security-based swap participants for which there is a prudential regulator (the "Prudentially Regulated Entities").[2] Additionally, the Commodity Futures Trading Commission (the "CFTC" and, together with the Prudential Regulators, the "Regulators") re-proposed rules providing for minimum margin requirements for uncleared swaps executed by swap dealers and major swap participants for which there is no prudential regulator (together with the Prudentially Regulated Entities, "swap entities").[3]

The proposed rules issued by the Regulators (together, the "Proposed Rules") are substantially similar to each other and to comparable requirements that have been proposed in the European Union. The margin requirements generally are intended to reduce risk in the financial markets and will represent a significant shift in the OTC derivatives market, by prescribing a number of requirements that previously had been privately negotiated by the parties to a derivative contract.

Some of the key features of the Proposed Rules are as follows:

- Mandatory bilateral, daily exchange of variation margin between parties to an uncleared swap where one party is a swap entity and the other party is a swap entity or a "financial end user" (as described in more detail below).
- Mandatory bilateral, daily exchange of initial margin between parties to an uncleared swap where one party is a swap entity and the other party is a swap entity or a financial end user with material swaps exposure (as described in more detail below).
- Variation margin must be in the form of cash, while initial margin must be in a form prescribed by the Proposed Rules, which includes cash, certain government securities, certain publicly traded securities, and gold.
- Initial margin collected by both the swap entity and the counterparty must be held with an independent, third-party custodian, although with respect to margin posted to a swap entity by a non-swap entity, only the initial margin required by law is required to be segregated.
- The parties will be required to enter into a written agreement regarding credit support arrangements (such as an ISDA Credit Support Annex) that specifies certain terms. ISDA Credit Support Annexes that are already in place will likely need to be amended to conform to the new requirements. Parties also will need to enter into triparty arrangements with respect to initial margin that is segregated pursuant to the rules.

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[1] The applicable federal banking regulators are the Department of the Treasury's Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency.
[2] Margin and Capital Requirements for Covered Swap Entities, 79 Fed. Reg. 57348 (Sept. 24, 2014).
[3] The CFTC's proposed rules have been posted on the CFTC's website but have not yet been published in the Federal Register. While the CFTC's margin rules do not apply to security-based swaps executed by security-based swap dealers and major security-based swap participants, which are subject to the jurisdiction of the Securities and Exchange Commission (the "SEC"), security-based swaps do count toward the calculation and application of the initial margin threshold amount and the calculation of material swaps exposure.

- The compliance date for mandatory exchange of variation margin is December 1, 2015. Compliance with the initial margin requirements will be phased in between December 1, 2015 and December 1, 2019, as described in more detail below.

The deadline for comments on the Prudential Regulators' proposed rules is November 24, 2014, and the deadline for comments on the CFTC's proposed rules will be sixty days following publication of the CFTC's proposed rules in the Federal Register, which has not occurred as of the date of this Alert.

Background. Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), the Regulators are responsible for adopting minimum margin requirements for swap entities' trading in uncleared swaps. The Prudential Regulators originally published proposed rules regarding margin requirements for uncleared swaps on May 11, 2011, and the CFTC and the SEC originally published proposed rules on April 28, 2011, and November 23, 2012, respectively. The Proposed Rules are materially different from the rules originally proposed by the Prudential Regulators and the CFTC (for example, the originally proposed rules provided only for minimum margin to be posted to swap entities, not bilateral exchange of margin). The SEC's proposed rules also differed in many respects from the Proposed Rules and it is not clear at this time if and when the SEC will re-propose its margin rules.

The Proposed Rules generally follow 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") and are generally consistent with draft rules published by ESMA in the European Union in April 2014, although there are a few differences.

What trades are covered by the new margin rules and when do the rules become effective?

Minimum *variation margin* requirements will apply to uncleared swaps between a swap entity, on the one hand, and a counterparty that is either a "financial end user"[4] or a swap entity, on the other hand. Minimum *initial margin* requirements will apply only to a subset of this group – uncleared swaps between a swap entity, on the one hand, and a counterparty that is either a "financial end user with material swaps exposure"[5] or a swap entity, on the other hand.

Minimum *initial and variation margin* requirements will ***not*** apply to any uncleared swaps between a swap entity, on the one hand, and a nonfinancial end user, sovereign, or multilateral development bank, on the other hand. Minimum *initial margin requirements* will ***not*** apply to uncleared swaps between a swap entity and a financial end user without material swaps exposure, but variation margin requirements will apply to such swaps. In these cases, the Prudential Regulators' proposed rules state that the swap entity should collect

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[4] The Regulators have proposed to include a list of entities that are "financial end users," which includes, 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, and commodity trading advisors, 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.

[5] "Material swaps exposure" means that the relevant entity and its affiliates have an average daily aggregate notional amount of uncleared swaps, security-based swaps, foreign exchange forwards and foreign exchange swaps with all counterparties for June, July and August of the previous year that exceeds $3 billion, where such amount is calculated only for business days. As noted in the Regulators' respective proposing releases, this threshold is lower than the threshold set forth in the Basel/IOSCO Framework, which defined smaller financial end users as those counterparties that have a gross aggregate amount of covered swaps below €8 billion (or approximately $10-11 billion at current exchange rates).

initial and/or variation margin at such times and in such forms and such amounts (if any) that the swap entity determines are appropriate to address the credit risk posed by the counterparty and the risks of such uncleared swaps. For risk management purposes, the CFTC's proposed rules require the swap entity to calculate hypothetical initial and variation margin amounts each day as if the non-financial end user were a swap entity, and to compare those amounts to the initial and variation margin actually required to be posted by the counterparty.

Pursuant to the Secretary of the Treasury's Determination published on November 20, 2012 (the "Determination"), certain physically settled foreign exchange swaps and deliverable foreign exchange forwards, as described in the Determination, are exempt from the margin requirements.

The Proposed Rules will apply to covered swaps entered into on or after the applicable compliance date (and to existing swaps that are rolled over or renewed on or after the applicable compliance date). The compliance date for the required exchange of variation margin is December 1, 2015. Compliance with the initial margin rules will be phased in between December 1, 2015 and December 1, 2019, 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 June, July and August of that year: (i) if such amount for both parties exceeds $4 trillion, the compliance date is December 1, 2015; (ii) if such amount for both parties exceeds $3 trillion, the compliance date is December 1, 2016; (iii) if such amount for both parties exceeds $2 trillion, the compliance date is December 1, 2017; (iv) if such amount for both parties exceeds $1 trillion, the compliance date is December 1, 2018; and (v) otherwise, the compliance date is December 1, 2019.

How is margin calculated? The Proposed Rules require the following amounts of minimum margin to be posted with respect to covered swaps:

> *Variation margin* will be required to be exchanged daily in an amount that is at least equal to the increase or decrease in the value of the swap since the counterparties' previous exchange of variation margin. The parties must exchange the full amount of variation margin, and are not permitted to adopt a threshold amount which will remain unsecured. Variation margin must be calculated (and exchanged, if necessary) on a daily basis for the life of the uncleared swap.
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> Under the Proposed Rules, the 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 $650,000 (which is higher than the minimum transfer amount currently specified in most ISDA Credit Support Annexes and also higher than the amount – $100,000 – that originally had been proposed by the Regulators).
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> Variation 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. If the parties do not wish for the new margin requirements to apply to trades in existence prior to December 1, 2015 pursuant to such a netting arrangement, the Prudential Regulators note in the preamble to their rules that the parties may enter into a separate master netting agreement for new uncleared swaps and retain the existing master netting agreement for existing uncleared swaps.

Initial margin will be determined either pursuant to (i) an initial margin risk-based model[6] approved by the appropriate regulator or (ii) a standardized look-up table[7] set forth in the Proposed Rules. Initial margin payments will be subject to a maximum threshold amount of $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). Initial margin must be calculated (and exchanged, if necessary) on a daily basis for the life of the uncleared swap.

What collateral is eligible to be posted?

Eligible collateral for variation margin is 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. Eligible collateral for initial margin includes the following:

- Cash (in the same forms as are permitted with respect to variation margin);
- U.S. Treasury securities;
- Certain U.S. government agency securities;
- Certain securities issued or guaranteed by U.S. government-sponsored enterprises;
- Any "major currency" (regardless of the currency in which payment obligations under the swap are required to be settled);
- Securities issued by the European Central Bank, the Bank for International Settlements, the International Monetary Fund, or a multilateral development bank;
- Certain publicly traded debt securities;
- Certain publicly traded common equity securities that are listed on the Standard & Poor's Composite 1500 Index or a comparable index thereto; and
- Gold.

In valuing eligible collateral in the form of securities, swap entities must apply discount haircuts set forth in the Proposed Rules, based on the type, issuer and remaining duration of the security.

How will margin be held?

The Proposed Rules impose certain collateral safekeeping requirements on initial margin that is posted or collected by a swap entity. Initial margin that is *posted* by a swap entity to a counterparty (whether or not such amount of initial margin is required by the Proposed Rules, is in excess of such amount, or is posted to a counterparty to which the swap entity is not required by the Proposed Rules to post such initial margin) must be held with a custodian that is not an affiliate of the swap entity or the counterparty.

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[6] If a model is used, the model must calculate potential future exposure of the uncleared swap(s), defined as an estimate of the one-tailed 99 percent confidence interval for an increase in the value of the uncleared swap or netting set of uncleared swaps due to an instantaneous price shock that is equivalent to a movement in all material underlying risk factors, including prices, rates, and spreads, over a holding period equal to the shorter of ten business days or the maturity of the swap. The model may reflect offsetting exposures, diversification, and other hedging benefits that are governed by the same eligible master netting agreement.

[7] The standardized method in the Proposed Rules is a table of initial margin requirements which vary from 1 to 4% of the notional amount for interest rate swaps and cross-currency swaps (depending on duration of the swap) and from 2 to 10% of the notional amount for credit swaps. Initial margin would be set at 15% of the notional amount for commodity swaps and equity swaps and 6% of the notional amount for foreign exchange/currency swaps.

The amount of initial margin that is required to be *collected* by a swap entity from a counterparty must be held with a custodian that is not an affiliate of either party. This requirement is narrower than the requirement with respect to collateral posted by the swap entity to the counterparty in that it only applies to the amount of initial margin that is required to be collected under the Proposed Rules and not to all collateral collected by the swap entity from the counterparty. Notably, this means that collateral posted to a swap entity by a nonfinancial end user, for example, will not be subject to a requirement that such collateral be held by an independent custodian.

Where collateral is required to be held by an independent custodian, such collateral must be held pursuant to a custodian agreement that meets certain requirements, including that such collateral may not be rehypothecated, repledged, reused or otherwise transferred. Substitution and reinvestment of collateral held in the custodial account is permitted, subject to certain conditions. The rules do not specify any requirements for "pledgor access" rights (*i.e.*, the right for the posting party to demand immediate return of pledged collateral upon default of the secured party), which many buy-side firms typically seek in triparty arrangements where initial margin is segregated with a third-party custodian.

The segregation requirements do not apply to variation margin.

Will the Proposed Rules apply to swaps involving entities outside of the United States?

Both the Prudential Regulators and the CFTC address, and seek comment on, the cross-border application of their respective rules. The Prudential Regulators' proposal would exclude from the margin requirements any foreign uncleared swap of a "foreign covered swap entity." The term "foreign covered swap entity" means any Prudentially Regulated Entity that is not (i) an entity organized under U.S. or state law (including a U.S. branch, agency, or subsidiary of a foreign bank), (ii) a branch or office of an entity organized under U.S. or state law, or (iii) an entity controlled by an entity organized under U.S. or state law. Note that this proposal differs from the CFTC's cross-border guidance published in July 2013 in a few ways. For example, a swap between a non-U.S. entity and non-U.S. swap entity that is controlled by a U.S. parent or that is guaranteed by a U.S. person would be subject to the Prudential Regulators' margin requirements.

The CFTC included with its proposed margin rules an advance notice of proposed rulemaking regarding the cross-border application of its margin rules. The CFTC seeks comment on three proposed models: (i) a model that would apply the margin requirements consistent with the CFTC's existing cross-border guidance; (ii) a model that generally follows the Prudential Regulators' proposed approach; and (iii) an alternative framework under which (A) U.S. swap entities and non-U.S. swap entities guaranteed by U.S. persons would generally have to comply with the Proposed Rules (subject to the possibility of substituted compliance with respect to the requirement to *post* margin to non-U.S. persons not guaranteed by U.S. persons), and (B) non-U.S. swap entities not guaranteed by a U.S. person would have the possibility of substituted compliance with the requirements of another jurisdiction (subject to a determination by the CFTC).

How consistent are the Proposed Rules with the equivalent European rules?

ESMA in the European Union (jointly with the European banking and insurance regulator) has put forward draft rules on the collateralization of uncleared OTC derivatives. These rules are consistent with the Proposed Rules in many key respects. In particular, requirements as to the exchange of variation margin and initial margin, the basis of calculation, threshold amounts and eligible collateral are largely consistent. The European Union has likewise put forward a requirement for segregation of all initial margin amounts (although the rules do not yet stipulate segregation with a third party custodian) – a requirement with a particular impact on EU dealers, who typically collect margin from EU counterparties on a title transfer, rather than a security interest, basis.

The consistency of European rules with U.S. rules is important for two reasons. First, many transactions may be subject to both sets of rules (for example, swaps between a U.S. person and a non-U.S. swap entity). Future rules *should* allow substitution of one set of rules for another where the rules are substantially equivalent to each other – which they presently appear to be, although that will depend on a determination by regulators in the future. Second, the consistency of European rules with U.S. rules may influence international securities dealers in booking trades in the European Union as against the U.S. (or vice versa), and it will be interesting to see if there is any scope for this type of regulatory arbitrage in the future.

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