

## NEW MARGIN REQUIREMENTS FOR UNCLEARED SWAPS

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One of the fundamental changes that the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”)<sup>1</sup> made in the financial markets has been to force most over-the-counter swap transactions onto exchanges and impose regulations on transactions that remain uncleared by a central counterparty. At the same time, laws and regulations adopted by the European Commission and other nations have imposed similar, but by no means identical, requirements on swap markets outside the United States. This article reviews one aspect of these changes in the over-the-counter swap markets: the new margin requirements for uncleared swaps. Because margin for uncleared swaps has to date been set by each dealer in negotiations with individual customers, the transition to margin requirements imposed by regulators is likely to be difficult. There have also been predictions that the discrepancies between the margin requirements proposed by U.S. regulators and those proposed by regulators outside the U.S. will result in fragmentation of the uncleared swap markets.

### **I. Background**

The Dodd-Frank Act, enacted on July 21, 2010,<sup>2</sup> requires swap dealers, major swap participants, security-based swap dealers and major security-based swap participants (each, a “swap entity” and, collectively, “swap entities”) to register with the Commodity Futures Trading Commission (“CFTC”) or the Securities and Exchange Commission (“SEC”).<sup>3</sup> The Dodd-Frank Act also requires the Office of the Comptroller of the Currency Treasury (“OCC”), the Board of Governors of the Federal Reserve

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<sup>1</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Public L. No. 111-203, 124 Stat. 1376 (2010).

<sup>2</sup> *Id.*

<sup>3</sup> *See* 7 U.S.C. § 6s(a) (2012); 15 U.S.C. § 78o-10(a).

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System (“Board”), the Federal Deposit Insurance Corporation (“FDIC”), the Farm Credit Administration (“FCA”) and the Federal Housing Finance Agency (“FHFA”) (collectively, “the Prudential Regulators”) to adopt joint rules for swap entities under their respective jurisdictions imposing initial and variation margin requirements on all swaps not cleared by a central counterparty (“CCP”).<sup>4</sup> The Dodd-Frank Act also requires the CFTC and the SEC separately to adopt rules imposing margin requirements for swap entities for which there is no Prudential Regulator.<sup>5</sup>

In April 2011, the CFTC proposed rules to implement the foregoing provisions of the Dodd-Frank Act,<sup>6</sup> and two weeks later the Prudential Regulators proposed substantially similar rules.<sup>7</sup> The SEC is not expected to propose similar rules for security-based swaps until next year. Before these rules became effective, in July 2012, the Basel Committee on Banking Supervision (“BCBS”) and the board of the International Organization of Securities Commissions (“IOSCO”) proposed an international framework for margin requirements on uncleared swaps with the goal of creating an international standard for uncleared swaps.<sup>8</sup> This international framework, finalized in September 2013<sup>9</sup>, articulates eight key principles for uncleared swaps margin rules:<sup>10</sup>

- 1) Appropriate margining practices should be in place with respect to all uncleared derivative transactions;
- 2) Financial firms and systemically important non-financial entities (covered entities) that engage in non-centrally cleared derivatives must exchange initial and variation margins;
- 3) The methodologies for calculating initial and variation margins should be consistent across covered entities and ensure that all counterparty risk exposures are covered with a high degree of confidence;
- 4) To ensure that collateral will generate proceeds sufficient to protect against losses in the event of a counterparty default, collateral should be highly liquid and should, after accounting for an appropriate haircut, be able to hold its value in a time of financial stress;
- 5) Initial margin should be exchanged on a gross basis and held in such a way as to ensure that: (a) the margin collected is immediately available to the collecting

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<sup>4</sup> See 7 U.S.C. § 6s(e)(2)(A)(ii); 15 U.S.C. § 78o-10(e)(2)(A)(ii).

<sup>5</sup> See 7 U.S.C. § 6s(e)(2)(B)(ii); 15 U.S.C. § 78o-10(e)(2)(B)(ii).

<sup>6</sup> Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 23,732 (Apr. 28, 2011).

<sup>7</sup> Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. 27,564 (May 11, 2011).

<sup>8</sup> See BASEL COMMITTEE ON BANKING SUPERVISION & BOARD OF THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, CONSULTATIVE DOCUMENT: MARGIN REQUIREMENTS FOR NON-CENTRALLY-CLEARED DERIVATIVES (2012).

<sup>9</sup> See BASEL COMMITTEE ON BANKING SUPERVISION & BOARD OF THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, MARGIN REQUIREMENTS FOR NON-CENTRALLY CLEARED DERIVATIVES (2014).

<sup>10</sup> See *id.* at 5.

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party in the event of the counterparty's default; and (b) the collected margin is subject to arrangements that fully protect the posting party;

- 6) Requirements for transactions between affiliates are left to the national supervisors;
- 7) Requirements for margining uncleared swaps should be consistent and not duplicative across jurisdictions; and
- 8) Margin requirements should be phased in over an appropriate period of time.

In September and October 2014, the CFTC<sup>11</sup> and the Prudential Regulators<sup>12</sup> re-proposed rules for margin requirements for uncleared swaps (the "CFTC Proposal" and the "PR Proposal," respectively). In re-proposing the rules, the regulators clearly took into account the BCBS/IOSCO framework, but nonetheless there are important discrepancies between the proposed rules and the framework.

## II. Scope of Coverage

The BCBS/IOSCO framework applies to all uncleared OTC derivatives.<sup>13</sup> The PR Proposal imposes initial and variation margin requirements on prudentially regulated swap entities such as registered swap dealers that are U.S. or foreign banks ("PR Covered Swap Entities") entering into uncleared swaps and security-based swaps with the types of counterparties discussed below.<sup>14</sup> PR Covered Swap Entities would be required to post and collect initial and variation margin when facing these counterparties even if the counterparties themselves are not subject to regulation under the Dodd-Frank Act.<sup>15</sup> The Prudential Regulators are proposing to adopt what they refer to as a risk-based approach.<sup>16</sup>

The CFTC Proposal imposes initial and variation margin requirements on swap dealers and major swap participants that are not regulated by a Prudential Regulator, such as registered swap dealers that are not U.S. or foreign banks ("CFTC Covered Swap Entities").<sup>17</sup> The CFTC Proposal generally applies only to uncleared swaps. However, deliverable foreign exchange forwards and foreign exchange swaps are not considered swaps under the Commodity Exchange Act as amended by the Dodd-Frank Act for purposes of uncleared swap margin requirements, as determined by the U.S. Department

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<sup>11</sup> Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 Fed. Reg. 59,898 (Oct. 3, 2014).

<sup>12</sup> Margin and Capital Requirements for Covered Swap Entities, 79 Fed. Reg. 57,348 (Sept. 24, 2014).

<sup>13</sup> Except, the Framework does not apply for physically settled foreign exchange forwards and swaps. *See* BASEL COMMITTEE ON BANKING SUPERVISION & BOARD OF THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, MARGIN REQUIREMENTS FOR NON-CENTRALLY CLEARED DERIVATIVES 7 (2014).

<sup>14</sup> *See* Margin and Capital Requirements for Covered Swap Entities, 79 Fed. Reg. 57,350.

<sup>15</sup> *See id.* at 57,354.

<sup>16</sup> *See id.*

<sup>17</sup> *See* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 Fed. Reg. 59,902.

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of Treasury in 2012.<sup>18</sup> As a result, PR Covered Swap Entities may be required to pay variation margin for foreign exchange forwards and foreign exchange swaps while CFTC Covered Swap Entities will not be required to pay it.<sup>19</sup>

### III. Counterparties

Both the PR Proposal and the CFTC Proposal distinguish among four different types of swap counterparties:

- 1) Counterparties that are themselves PR Covered Swap Entities;
- 2) Counterparties that are financial end users with a material swaps exposure;
- 3) Counterparties that are financial end users without a material swaps exposure; and
- 4) All other counterparties.<sup>20</sup>

The PR Proposal provides a list of entities that would qualify as financial end users<sup>21</sup> as well as a list of entities excluded from that definition.<sup>22</sup> It is not consistent with the definition of a “financial entity” in Section 2(h) of the Commodity Exchange Act<sup>23</sup>, which on its own is likely to cause confusion in the markets. In addition, the enactment of the Business Risk Mitigation and Price Stabilization Act of 2015 (the “RMPS Act”) on January 13, 2015 appears to have heightened the significance of such confusion. By way of background, the RMPS Act amends sections 731 and 764 of the Dodd-Frank Act to provide that rules with respect to initial and variation margin requirements adopted by the CFTC, the SEC and the Prudential Regulators will not be applicable to entities that qualify for the end-user exception to the mandatory clearing requirement set forth in section 2(h)(7)(A) of the Commodity Exchange Act and corresponding section 3C(g)(1) of the Securities Exchange Act. This statutory exemption is available to any entity that: (i) is not a financial entity; (ii) uses swaps to hedge or mitigate commercial risk; and (iii) notifies the CFTC regarding the manner in which it generally meets its financial obligations in respect of uncleared swaps. The “is not a financial entity” condition is with reference to the definition of “financial entity” set forth in section 2(h)(7)(C) of the CEA. However, in an attempt to avoid difficulties experienced in determining which market participants should qualify as “financial entities” pursuant to the statutory language, the CFTC and the Prudential Regulators sought in the PR Proposal and the CFTC Proposal to provide clarity about whether particular entities would be subject to the margin rules by including in the repropose rules the alternative concept of “financial end user.” But at the time of this writing, considering that the RMPS Act specifically

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<sup>18</sup> Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, 77 Fed. Reg. 69,694 (Nov. 20, 2012).

<sup>19</sup> See Margin and Capital Requirements for Covered Swap Entities, 79 Fed. Reg. 57,351.

<sup>20</sup> See Margin and Capital Requirements for Covered Swap Entities, 79 Fed. Reg. at 57,398; Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 Fed. Reg. at 59,926.

<sup>21</sup> See Margin and Capital Requirements for Covered Swap Entities, 79 Fed. Reg. at 57,360.

<sup>22</sup> See *id.* at 57,362.

<sup>23</sup> See 7 U.S.C. § 2(h)(7)(C)(i).

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refers to “financial entity” instead of “financial end user”, it is unclear whether the CFTC and the Prudential Regulators will continue to rely in the final rules on the current definition of “financial end user” or will instead conform to the statutory definition of “financial entity”.

Under the PR Proposal, financial end users include banks; credit unions; broker-dealers, investment advisers, CPOs, CTAs or FCMs; investment funds, including a private fund under Section 202(a) of the Investment Advisers Act; investment vehicles operating in reliance on Section 3(c)(5)(C) or Rule 3a-7 of the 1940 Act; and insurance companies.<sup>24</sup> “Financial end user” is defined in the CFTC Proposal in substantially the same way as in the PR Proposal<sup>25</sup>, but there are slight differences.

In the PR Proposal and the CFTC Proposal, “material swaps exposure” is defined to mean that a counterparty has a consolidated average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange forwards and foreign exchange swaps with all other counterparties for June through August of the previous year that exceeds \$3 billion.<sup>26</sup>

The definition of financial end users is so broad that it will require exceptions to be made, either in the final rules or in no-action letters, in order to avoid unintended disruptions of markets. For example, it includes securitization vehicles<sup>27</sup>, and these entities do not currently post margin on uncleared swaps and in most cases are prohibited by their transaction documents and rating agency criteria from doing so. Structured finance transactions where the swap counterparty is either secured by a senior claim on pledged collateral held by a special purpose vehicle or is otherwise entitled to a senior priority claim on the assets of the special purpose vehicle do not pose systemic risk to the broader market. Such credit support arrangements protect swap counterparties without the use of initial margin or variation margin as required under the proposed rules.

#### **IV. Margin Requirements by Counterparty**

PR Covered Swap Entities must collect and post a minimum amount of initial margin when entering into an uncleared swap with any other PR Covered Swap Entity and with any financial end user that has a material swaps exposure.<sup>28</sup> Variation margin requirements would apply to swap transactions where a PR Covered Swap Entity enters into a trade with another PR Covered Swap Entity or a financial end user (regardless of whether the financial end user has a material swaps exposure).<sup>29</sup> A PR Covered Swap Entity may make its own credit judgment about whether to collect initial margin or

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<sup>24</sup> See Margin and Capital Requirements for Covered Swap Entities, 79 Fed. Reg. at 57,390.

<sup>25</sup> See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 Fed. Reg. at 59,926.

<sup>26</sup> See *id.* at 59,927 & Margin and Capital Requirements for Covered Swap Entities, 79 Fed. Reg. at 57,391.

<sup>27</sup> See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 Fed. Reg. at 59,903 & Margin and Capital Requirements for Covered Swap Entities, 79 Fed. Reg. at 57,361.

<sup>28</sup> See Margin and Capital Requirements for Covered Swap Entities, 79 Fed. Reg. at 57,391.

<sup>29</sup> See *id.* at 57,392.

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variation margin from other types of counterparties based on the credit risk posed by the counterparty and the risks of such swaps or security-based swaps.<sup>30</sup>

The CFTC Proposal requires CFTC Covered Swap Entities to post and collect initial margin for uncleared swaps from any counterparty that is a CFTC Covered Swap Entity or financial end user with material swaps exposure.<sup>31</sup> A CFTC Covered Swap Entity must post and collect variation margin in transactions with another CFTC Covered Swap Entity or a financial end user (regardless of whether the counterparty has material swaps exposure).<sup>32</sup> There is no requirement for CFTC Covered Swap Entities to exchange margin with non-financial end users. However, CFTC Covered Swap Entities are permitted to agree to initial and variation margin requirements and thresholds with such non-financial end users.

This aspect of the proposed rules represents a departure from the BCBS/IOSCO framework, under which initial margin is not required to be posted or collected by entities with an average daily aggregate notional amount of uncleared swaps below approximately \$11 billion.<sup>33</sup>

## V. Initial Margin Calculation Methodology

For initial margin, the PR Proposal would require a PR Covered Swap Entity to calculate its minimum initial margin requirement in one of two ways. It may use a standardized margin schedule set forth in the PR Proposal, or it may use an internal margin model that satisfies criteria set forth in the PR Proposal and has been approved by the Prudential Regulator.<sup>34</sup> Like the PR Proposal, the CFTC Proposal permits CFTC Covered Swap Entities to calculate initial margin by using either a risk-based model or a standardized table method.<sup>35</sup>

In their comment letters, many swap market participants argued that each covered swap entity should be permitted to use its proprietary initial margin model, rather than being required by the proposed rules to use a model from a vendor or clearing organization or a model that has been approved by the Prudential Regulators.<sup>36</sup>

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<sup>30</sup> *See id.* at 57,391, 57,392.

<sup>31</sup> *See* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 Fed. Reg. 59,928.

<sup>32</sup> *See id.*

<sup>33</sup> *See* BASEL COMMITTEE ON BANKING SUPERVISION & BOARD OF THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, MARGIN REQUIREMENTS FOR NON-CENTRALLY CLEARED DERIVATIVES 10 (March 2014).

<sup>34</sup> *See* Margin and Capital Requirements for Covered Swap Entities, 79 Fed. Reg. at 57,393.

<sup>35</sup> *See* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 Fed. Reg. at 59,929.

<sup>36</sup> *See e.g.* ISDA / SIFMA Joint Comment Letter addressed to the CFTC (September 14, 2012); SIFMA Comment Letter addressed to Prudential Regulators (March 12, 2014).

## VI. Calculating Variation Margin

Unlike the PR Proposal, the CFTC Proposal requires control mechanisms for the calculation of variation margin.<sup>37</sup> A CFTC Covered Swap Entity must create and maintain documentation setting forth its calculation methodology to allow the counterparty, the CFTC and any Prudential Regulator to calculate a reasonable approximation of the margin requirement independently.<sup>38</sup> It is also required to evaluate the reliability of its data sources at least annually and make adjustments, as appropriate.<sup>39</sup> In addition, the CFTC Proposal requires a CFTC Covered Swap Entity to have in place alternative methods for determining the value of an uncleared swap in the event of the unavailability of any input required to value a swap, and the CFTC may at any time require a CFTC Covered Swap Entity to provide further data or analysis concerning the methodology or data source used to value a swap for variation margin purposes.<sup>40</sup>

## VII. Thresholds

Under the PR Proposal, initial margin must be posted and collected on a daily basis (with the collection and posting of initial margin beginning no later than the business day following the day of entry into the swap) in response to changes in portfolio composition or other factors that would change the required initial margin amounts.<sup>41</sup> PR Covered Swap Entities are permitted to adopt a maximum initial margin threshold of \$65 million, below which they need not collect or post initial margin from or to other PR Covered Swap Entities or financial end users with material swaps exposure.<sup>42</sup> The threshold would be applied on a consolidated basis and would apply both to the consolidated PR Covered Swap Entity as well as to the consolidated counterparty.<sup>43</sup> With respect to variation margin, no threshold amounts would be permitted; but a minimum transfer amount of \$650,000 is permitted (the minimum transfer amount applies to all margin posted, initial and variation margin combined).<sup>44</sup> Variation margin also would be required to be posted and collected on a daily basis.<sup>45</sup>

The CFTC Proposal, like the PR Proposal, permits a CFTC Covered Swap Entity to reduce the amount of initial margin by a threshold amount that is established by the CFTC Covered Swap Entity but that may be no greater than \$65 million.<sup>46</sup> The initial margin threshold amount must be applied on a consolidated basis. Initial margin must be posted and collected on a daily basis commencing on or before the business day after

<sup>37</sup> See 79 Fed. Reg. at 59,931.

<sup>38</sup> *Id.*

<sup>39</sup> *Id.*

<sup>40</sup> *Id.*

<sup>41</sup> See Margin and Capital Requirements for Covered Swap Entities, 79 Fed. Reg. at 57,391.

<sup>42</sup> See *id.* at 57,390.

<sup>43</sup> See *id.* at 57,366.

<sup>44</sup> See *id.* at 57,392.

<sup>45</sup> See *id.*

<sup>46</sup> See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 Fed. Reg. at 59,927 (defining initial margin threshold amount).

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execution of an uncleared swap.<sup>47</sup>

Swap market participants have objected to these standardized thresholds, arguing that instead the rules should permit each covered swap entity to determine the relevant thresholds for its counterparties, subject to regulatory review.<sup>48</sup>

### VIII. Eligible Collateral

Although the BCBS/IOSCO framework does not distinguish between forms of initial and variation margin collateral<sup>49</sup>, the proposed rules permit a wide variety of securities to be delivered as initial margin while restricting variation margin to cash. Under the PR Proposal, eligible collateral is limited to high-quality assets that are expected to remain liquid and retain their value, after accounting for an appropriate risk-based haircut. Eligible collateral for variation margin is limited to cash in U.S. dollars or the currency in which payment obligations under the swap are required to be settled.<sup>50</sup> Eligible collateral for initial margin includes cash, U.S. treasuries and agencies, certain foreign government debt securities, certain corporate debt securities, certain listed equities or gold.<sup>51</sup> The value of any eligible collateral that is collected and held to satisfy initial margin requirements is subject to the haircuts described in the PR Proposal.<sup>52</sup> A PR Covered Swap Entity is required to monitor the market value and eligibility of all collateral to satisfy the initial margin requirements.<sup>53</sup> To the extent that the market value of such collateral has declined or if it is no longer eligible collateral, the PR Covered Swap Entity must promptly collect additional eligible collateral.<sup>54</sup>

The list of eligible collateral (including haircuts) in the CFTC Proposal is substantially the same as in the PR Proposal.<sup>55</sup> CFTC Covered Swap Entities also are required to monitor the market value and eligibility of all collateral collected to satisfy initial margin requirements.

This is another aspect of the proposed rules where swap market participants have commented that the rules should permit covered swap entities to determine eligible collateral and relevant haircuts for such collateral, subject to regulatory review.<sup>56</sup>

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<sup>47</sup> See *id.* at 59,928.

<sup>48</sup> See *e.g.* ISDA / SIFMA Joint Comment Letter addressed to the CFTC (July 11, 2011); ISDA / SIFMA Joint Comment Letter addressed to the CFTC (September 14, 2012); SIFMA Asset Management Group Comment Letter addressed to the CFTC (September 28, 2012).

<sup>49</sup> See BASEL COMMITTEE ON BANKING SUPERVISION & BOARD OF THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, MARGIN REQUIREMENTS FOR NON-CENTRALLY CLEARED DERIVATIVES 17 (March 2014).

<sup>50</sup> See Margin and Capital Requirements for Covered Swap Entities, 79 Fed. Reg. at 57,392.

<sup>51</sup> See *id.*

<sup>52</sup> See *id.*

<sup>53</sup> See *id.*

<sup>54</sup> See *id.*

<sup>55</sup> See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 Fed. Reg. at 59,931.

<sup>56</sup> See *e.g.* ISDA / SIFMA Joint Comment Letter addressed to the CFTC (September 14, 2012); ISDA Comment Letter addressed to the Prudential Regulators (November 26, 2012).



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## IX. Custodial Agreements and Segregation

Under the PR Proposal, initial margin must be segregated at custodians that are not affiliates of the PR Covered Swap Entity or the counterparty.<sup>57</sup> On the other hand, variation margin is not required to be segregated at an independent third-party custodian.<sup>58</sup> The segregation requirement applies only to the minimum amount of initial margin that a PR Covered Swap Entity is required to collect from a swap entity or a financial end user with material swaps exposure; however, it applies to all collateral (other than variation margin) that the PR Covered Swap Entity posts to any counterparty.<sup>59</sup> The custodial agreement must prohibit rehypothecating, repledging, reusing or otherwise transferring any of the funds the third-party custodian holds.<sup>60</sup> Substitution of collateral and reinvestment of posted collateral is permitted.<sup>61</sup> Unlike initial margin, variation margin may be rehypothecated by the recipient.<sup>62</sup>

Similar to the PR Proposal, the CFTC Proposal requires any initial margin posted by a CFTC Covered Swap Entity, and the initial margin that is required to be collected by a CFTC Covered Swap Entity, to be held by an independent third-party custodian.<sup>63</sup> The CFTC Proposal, like the PR Proposal, requires the custodian agreement to limit rehypothecation and to permit substitution and reinvestment of collateral.

Under the BCBS/IOSCO framework, the customer has the option to segregate initial margin<sup>64</sup> and the customer may consent to rehypothecation.<sup>65</sup> The PR Proposal and the CFTC Proposal are therefore more restrictive than the BCBS/IOSCO framework since under the PR Proposal and the CFTC Proposal segregation is required and rehypothecation is prohibited.

In comment letters swap market participants have expressed a desire to continue the current practice, which these segregation requirements would ban, of allowing parties to agree that the custodian for their margin will be an affiliate of either counterparty.<sup>66</sup>

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<sup>57</sup> See Margin and Capital Requirements for Covered Swap Entities, 79 Fed. Reg. at 57,393.

<sup>58</sup> *See id.* at 57,356.

<sup>59</sup> *See id.* at 57,393.

<sup>60</sup> *See id.*

<sup>61</sup> *See id.*

<sup>62</sup> *See id.*

<sup>63</sup> See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 Fed. Reg. at 59,932.

<sup>64</sup> See BASEL COMMITTEE ON BANKING SUPERVISION & BOARD OF THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, MARGIN REQUIREMENTS FOR NON-CENTRALLY CLEARED DERIVATIVES 20 (March 2014).

<sup>65</sup> *See id.* at 21.

<sup>66</sup> See e.g. ISDA / SIFMA Joint Comment Letter addressed to the CFTC (September 14, 2012); ISDA Comment Letter addressed to the Prudential Regulators (November 26, 2012); ISDA Comment Letter addressed to the Prudential Regulators (November 24, 2014); Managed Funds Association Comment Letter addressed to the Prudential Regulators (November 24, 2014).

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## X. Interaffiliate Swaps

The PR Proposal and the CFTC Proposal do not provide an exemption from these margin requirements for uncleared swap transactions between affiliates. The BCBS/IOSCO framework left the decision to national supervisors<sup>67</sup>, so if national supervisors outside the United States provide an exemption, it could place U.S. entities at a competitive disadvantage.

The exemption of inter-affiliate swaps is an issue that swap market participants, particularly global financial entities that have historically used back-to-back swaps to consolidate and manage market risk exposures centrally at a single affiliate, have consistently (and almost universally) requested.<sup>68</sup> The generally expressed rationale for such an exemption is that inter-affiliate swaps do not increase systemic risk because losses on a trade that accrue to one affiliate are equally offset by gains to the affiliate on the other side of the trade, resulting in a net wash for the consolidated entities. So posting of collateral for inter-affiliate swaps is not necessary to control systemic risk.

## XI. Netting and Treatment of Legacy Trades

Under the PR Proposal and the CFTC Proposal, the margin amounts posted and received for transactions made under an eligible master netting agreement could be fully netted. While the margin requirements would not be applicable to trades entered into prior to the effective date of the new rules, if such “legacy” trades were made under the same master netting agreement as new trades made after the effective date, such legacy trades would be required to satisfy the new margin requirements.<sup>69</sup>

The proposal by the U.S. regulators to condition grandfathering of legacy trades on the documentation of those swaps under separate eligible master netting agreements from new swaps, would increase credit risk and systemic risk by reducing the netting of trades.<sup>70</sup> Cross-product portfolio margining arrangements across cleared and uncleared swaps and other non-derivative products remain a critical issue for market participants.<sup>71</sup>

## XII. Trading Documentation

The PR Proposal requires the trading agreements between a PR Covered Swap Entity and a counterparty that is either another PR Covered Swap Entity or a financial end user to include credit support provisions that meet the requirements of the rule.<sup>72</sup>

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<sup>67</sup> See BASEL COMMITTEE ON BANKING SUPERVISION & BOARD OF THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, MARGIN REQUIREMENTS FOR NON-CENTRALLY CLEARED DERIVATIVES 22 (March 2014).

<sup>68</sup> See e.g. SIFMA Comment Letter addressed to the Prudential Regulators (March 12, 2014); ISDA Comment Letter addressed to the Prudential Regulators (November 26, 2012).

<sup>69</sup> See Margin and Capital Requirements for Covered Swap Entities, 79 Fed. Reg. at 57,392.

<sup>70</sup> See Managed Funds Association Comment Letter addressed to the Prudential Regulators (November 24, 2014).

<sup>71</sup> See e.g. Managed Funds Association Comment Letter addressed to the Prudential Regulators (November 26, 2012); Managed Funds Association Comment Letter addressed to the CFTC (July 11, 2011); ISDA Comment Letter addressed to the Prudential Regulators (November 26, 2012).

<sup>72</sup> See Margin and Capital Requirements for Covered Swap Entities, 79 Fed. Reg. at 57,395.

Such credit support arrangements must specify the methods, procedures, rules and inputs for determining the value of each swap and contain dispute resolution procedures.<sup>73</sup> In contrast, the CFTC Proposal requires CFTC Covered Swap Entities to enter into trading agreements that contain such credit support provisions with all uncleared swap counterparties, including non-financial end users.<sup>74</sup>

CFTC rules and regulations already require swap trading documentation to include methods, procedures, rules and inputs for swap valuation and a valuation dispute resolution process and disclosure of the methodology and assumptions used to prepare the daily mark.<sup>75</sup> The proposed rules are duplicative and impose additional documentation requirements related to valuation that are unnecessary and will be burdensome for swap market participants.

### **XIII. Effective Dates**

If the proposed rules are implemented, as currently drafted, PR Covered Swap Entities and CFTC Covered Swap Entities will need to comply with the margin requirements for swaps entered into on or after December 1, 2015 with respect to variation margin.<sup>76</sup> For initial margin the compliance date is December 1, 2015 if both the PR Covered Swap Entity (and its affiliates) or the CFTC Covered Swap Entity (and its affiliates), as applicable, 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 for June through August 2015 that exceeds \$4 trillion.<sup>77</sup> However, if a party has a lower volume of uncleared swap and foreign exchange trading, the effective date is deferred to December 1, 2016, if for June through August 2016 such volume exceeds \$3 trillion; December 1, 2017, if for June through August 2017 it exceeds \$2 trillion; and December 1, 2018, if for June through August 2018 it exceeds \$1 trillion.<sup>78</sup> The new requirements will become effective for all counterparties on December 1, 2019.<sup>79</sup>

It is unlikely that the final rules will be finalized before mid-2015. As a result, market participants will have very little time before the December 1, 2015 deadline to put the necessary legal, operational, risk management and technology in place to implement these new regulations. A deferral of the proposed effective dates is needed to provide

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<sup>73</sup> See *id.* at 57,382.

<sup>74</sup> See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 Fed. Reg. at 59,932.

<sup>75</sup> See, e.g., 17 CFR 23.504.

<sup>76</sup> See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 Fed. Reg. at 59,932 & Margin and Capital Requirements for Covered Swap Entities, 79 Fed. Reg. at 57,388.

<sup>77</sup> See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 Fed. Reg. at 59,932 & Margin and Capital Requirements for Covered Swap Entities, 79 Fed. Reg. at 57,389.

<sup>78</sup> See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 Fed. Reg. at 59,932 & Margin and Capital Requirements for Covered Swap Entities, 79 Fed. Reg. at 57,388.

<sup>79</sup> See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 Fed. Reg. at 59,932 & Margin and Capital Requirements for Covered Swap Entities, 79 Fed. Reg. at 57,389.

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additional time after the finalization of the rules is necessary to ensure a smooth and efficient implementation of the rules.

However, on March 18, 2015 the BCBS and IOSCO jointly announced that the implementation schedule set forth in the international framework was being extended by nine months. In addition, the requirement to exchange variation margin was made subject to a six month phase-in period.<sup>80</sup> The U.S. regulators have not yet officially followed suit, but CFTC Commissioner Timothy Massad has been quoted as stating that the CFTC is also considering pushing back its implementation timeline by a matter of months.<sup>81</sup>

#### **XIV. Extraterritoriality**

The PR Proposal excludes any foreign non-cleared swap or foreign non-cleared security-based swap of a foreign covered swap entity.<sup>82</sup> A “foreign non-cleared swap” is an uncleared swap of a foreign covered swap entity where neither the counterparty nor any guarantor of either party is: (1) organized under the laws of the United States or any state (including a U.S. branch, agency or subsidiary of a foreign bank); (2) a branch or office of an entity organized under the laws of the United States or any state; or (3) a PR Covered Swap Entity controlled by an entity organized under the laws of the United States or any state.<sup>83</sup> A “foreign covered swap entity” is a PR Covered Swap Entity that is not: (1) organized under the laws of the United States or any state (including a U.S. branch, agency or subsidiary of a foreign bank); (2) a branch or office of an entity organized under the laws of the United States or any state; or (3) a PR Covered Swap Entity controlled by an entity organized under the laws of the United States or any state.<sup>84</sup> In addition to the foregoing exclusion, the PR Proposal would permit “substituted compliance”: Foreign covered swap entities could meet the requirements of the rule by complying with the requirements of a non-U.S. regulator in the event that a comparability determination is made by the Prudential Regulators, provided that the covered swap entity’s obligations under the swap are not guaranteed by a U.S. entity.<sup>85</sup>

Unlike the PR Proposal, the CFTC Proposal does not include exemptions to its margin requirements for transactions outside the United States markets. The CFTC Proposal includes an advance notice of proposed rulemaking and asks for public comment on alternative approaches including: (1) application of the rules according to the PR Proposal; or (2) application of the uncleared swap margin CFTC rules according

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<sup>80</sup> See BASEL COMMITTEE ON BANKING SUPERVISION & BOARD OF THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, MARGIN REQUIREMENTS FOR NON-CENTRALLY CLEARED DERIVATIVES 24 (2015) available at <http://www.bis.org/bcbs/publ/d317.pdf>.

<sup>81</sup> Philip Stafford, *Hopes quashed of two-year delay for new swaps rules*, FINANCIAL TIMES (Mar. 11, 2015), <http://www.ft.com/intl/cms/s/0/15a8496e-c80e-11e4-8210-00144feab7de.html?siteedition=intl#axzz3UYwoM5Rn>.

<sup>82</sup> See Margin and Capital Requirements for Covered Swap Entities, 79 Fed. Reg. at 57,395.

<sup>83</sup> See *id.*

<sup>84</sup> See *id.*

<sup>85</sup> See *id.*

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to the “transaction-level requirements” of the CFTC’s earlier cross-border guidance or the “entity-level requirements.”<sup>86</sup>

One issue on which all swap market participants agree is “harmonization”: margin rules should be consistent across different jurisdictions and within the United States or, at a minimum, require a transaction to comply with only one jurisdiction’s rules where such harmony is lacking.<sup>87</sup> In the U.S., the SEC has yet to re-propose its rules on margin. And with respect to the CFTC Proposal, there has been no determination to permit substituted compliance for non-U.S. margin rules that are consistent with the BCBS/IOSCO framework. Substituted compliance is necessary to avoid having margin rules from two different jurisdictions with inconsistent requirements applying simultaneously to the same collateral transfer.

Swap market participants have argued that swaps between non-U.S. covered swap entities and non-U.S. counterparties should not be subject to the U.S. margin rules, even if such entities are affiliated with U.S. companies.<sup>88</sup> The definition of what is a “non-U.S.” entity is also crucial: non-U.S. covered swap entities should include non-U.S. branches, offices, subsidiaries and other non-U.S. affiliates of U.S. entities, and non-U.S. counterparties should include non-U.S. funds or other entities with a U.S. advisor and non-U.S. entities guaranteed by a U.S. entity.

## **XV. Impact of Re-Proposed Margin Rules**

Margin requirements today are established through bilateral negotiations between a dealer and its counterparty, and two-way margining is not current market practice for many participants in the swap market. As a result, market participants will be required to make changes in longstanding business practices as well as significant investments to improve their collateral infrastructure. Collateral account control agreements with third-party custodians will need to be negotiated. Systems will need to be updated to support the new margin calculations, and reporting capabilities will need to be enhanced to track collateral.

Mandatory margin requirements are expected to lead to higher costs and reduced liquidity for uncleared swaps. Since initial margin will not be permitted to be rehypothecated, industry participants will need a consistent supply of eligible collateral, which may result in a shortage of, and possibly a squeeze on, eligible collateral. Counterparties may be increasingly reliant on transformation services if this shortage of eligible assets develops; dealers providing transformation services will lend eligible

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<sup>86</sup> See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 Fed. Reg. at 59,916.

<sup>87</sup> See e.g. ISDA / SIFMA Joint Comment Letter addressed to the CFTC (July 11, 2011); SIFMA Asset Management Group Comment Letter addressed to the Prudential Regulators (November 26, 2012); Managed Funds Association Comment Letter addressed to the Prudential Regulators (November 24, 2014).

<sup>88</sup> See e.g. ISDA / SIFMA Joint Comment Letter addressed to the CFTC (July 11, 2011); ISDA Comment Letter addressed to the Prudential Regulators (November 26, 2012); ISDA / SIFMA Comment Letter addressed to the Prudential Regulators (November 24, 2014).

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collateral to counterparties for a fee.

In addition, risk may also increase as the cost of customizing risk management tools will increase, causing counterparties to use more standardized swaps, which are less tailored to reduce the specific risks to which counterparties are exposed. Risk will concentrate at central counterparty clearing houses as trades move away from the more expensive uncleared swaps market. Such concentration at the central counterparties may have adverse consequences if risk management is not improved at central counterparties. If the margin requirements for uncleared swaps become too costly, the markets for uncleared swaps may become disrupted and no longer viable, thereby adversely affecting the ability of market participants to manage risk effectively.

## **XVI. Conclusion**

ISDA estimates that as much as \$1 trillion of new collateral may need to be posted if the rules for margin for uncleared swaps proposed by the CFTC and Prudential Regulators are adopted.<sup>89</sup> This increased collateral demand would have a significant impact on financial markets. While most swap market participants generally support measures to reduce risk in the swaps markets and incentivize clearing of swaps, many have expressed concerns that the proposed rules will have unintended consequences that will increase systemic risk and disrupt these markets. The rules need to appropriately address the particular risks posed by uncleared swap transactions. As currently proposed, the margin rules for uncleared swaps may be too costly and punitive. If the market for uncleared swaps loses its viability, market participants will not be able to manage risk effectively. Market participants need a well-functioning market for uncleared swaps in order to meet their trading and risk management needs, which often require the customized transactions which exchanges cannot by their nature offer.

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<sup>89</sup> ISDA/ SIFMA Joint Comment Letter addressed to the Prudential Regulators (July 6, 2011).