

US Regulators Adopt Final Rule On Margin Requirements For Non-Cleared Swaps

CRAIG STEIN and SEAN D. LOCKLEAR, STRUCTURED FINANCE & DERIVATIVES GROUP, SCHULTE ROTH & ZABEL

On 22 October 2015 a group of five banking regulators (the “prudential regulators”) adopted a final rule establishing minimum margin and capital requirements for non-cleared swaps and non-cleared security-based swaps.¹ The Final Rule, which does not begin phasing in until September 2016, applies to swaps executed by swap dealers, major swap participants, security-based swap dealers and major security-based swap participants for which one of the federal agencies is the prudential regulator (each, a “covered swap entity”).² Although most investment managers and other buy-side firms are already margining non-cleared swaps under ISDA master agreements and credit support annexes, the Final Rule imposes material obligations on swap dealers that diverge from current industry practice. This likely will require amendments to current trading documentation and result in increased costs for many market participants.

In Brief

- Dealers soon will be required to collect and post initial margin with certain swap counterparties with high levels of exposure to non-cleared swaps, and such initial margin must be segregated with a third-party custodian.
- Dealers may impose an initial margin threshold of up to \$50 million, lessening the rule’s impact.
- Parties to non-cleared swaps generally will be required to exchange variation margin on a daily basis regardless of the counterparty’s non-cleared swap exposure level.
- Investment managers will be required to make certain determinations in order to establish the Final Rule’s applicability and relevant compliance dates.
- Entities managed by the same investment manager are unlikely to be considered “affiliates,” and managers therefore will be required to make entity-level determinations.
- Even funds with limited exposure to non-cleared swaps likely will be required to amend trading documentation, which may eventually be incorporated as a new ISDA protocol.

Background

The Dodd-Frank Act requires the prudential regulators to adopt joint rules for covered swap entities under their respective jurisdictions imposing initial and variation margin requirements for all swaps not centrally cleared.³ The prudential regulators issued proposed rules in May 2011 and again in September 2014, each of which garnered extensive comments from the derivatives community.⁴ The Final Rule is largely based on these proposals, but differs in several material respects as described in this alert.

In addition to the prudential regulators’ rule, the Dodd-Frank Act requires the CFTC and SEC separately to adopt rules imposing margin requirements for swap entities for which there is no prudential regulator. While the SEC has yet to act, the CFTC issued its own proposed rule in April 2011, and a final rule is expected to be adopted in short order. On an international level, the Basel Committee on Banking Supervision (“BCBS”) and the board of the International Organisation of Securities Commissions (“IOSCO”) in July 2012 proposed a framework for margin requirements on non-cleared swaps with the intention of creating an international standard.⁵ Although gaps persist between the various frameworks, the prudential regulators modified many provisions from the proposed rule to more closely align with the BCBS/IOSCO framework.

‘Financial End Users’ and ‘Material Swaps Exposure’

The Final Rule imposes varying obligations on covered swap entities depending on whether their counterparty is a “financial end user.” The prudential regulators defined this term by reference to an enumerated list of entity types in an attempt to provide more certainty than was offered by the corresponding CFTC definition of “financial entity.” The expansive list casts a wide net over various forms of pooled investment vehicles, including registered funds, private funds and commodity pools.

The Final Rule further distinguishes between financial end users based on whether such

entities have a “material swaps exposure.” A counterparty has a material swaps exposure if it and its affiliates (discussed below) have an average daily aggregate notional amount of non-cleared swaps with all counterparties for business days in June, July and August of the previous calendar year that exceeds \$8 billion.⁶ This figure represents an increase from the \$3 billion threshold in the proposed rule and is intended to be consistent with the €8 billion threshold established in the BCBS/IOSCO framework. Covered swap entities are permitted to rely on representations from counterparties as to whether they have a material swaps exposure, so investment managers should be prepared to make this determination.

The Final Rule adopts a modified definition of “affiliate” based on accounting treatment instead of the 25-percent ownership/control framework used in the proposed rule. Two entities will be considered affiliated if either entity consolidates the other on financial statements prepared in accordance with US GAAP, the International Financial Reporting Standards or other similar standards. The prudential regulators noted in the text of the preamble that in most cases they would not expect separate funds of a single investment manager to be consolidated under relevant accounting standards and thus would not be considered affiliates for purposes of the Final Rule.⁷

Margin Requirements by Counterparty

Covered swap entities must both collect and post initial margin for swaps entered into with financial end users that have a material swaps exposure.⁸ This deviates from current market practice as dealers would rarely, if ever, post initial margin under an ISDA relationship. However, the Final Rule permits covered swap entities to apply a threshold of up to \$50 million, meaning that dealers will not be required to collect or post initial margin to the extent the aggregate un-margined exposure to or from a swap counterparty and its affiliates is below \$50 million.⁹ Covered swap entities do not have any obligation to collect or post initial margin with a non-financial end user

or a financial end user without a material swaps exposure.¹⁰ The Final Rule generally requires a covered swap entity to collect and post variation margin for all swaps entered into with a financial end user regardless of material swaps exposure. Unlike initial margin, there is no allowable threshold for variation margin.

Margin Calculations and Eligible Collateral

Initial margin must be calculated in one of two ways. Covered swap entities may use a proprietary margin model that meets certain requirements and is approved by the prudential regulators. Such internal models must categorise each swap by asset class and may not offset common risks across asset classes.¹¹ Alternatively, covered swap entities may impose initial margin requirements based on a standardised margin schedule set forth in the Final Rule. In order to prevent “cherry picking” between the two models, the prudential regulators noted that absent a significant change in the nature of a counterparty’s swap activities, covered swap entities should not switch between a proprietary model and the standardised model for a particular counterparty and should be able to provide a rationale for any such change upon request.

Covered swap entities must collect and post variation margin in an amount corresponding to the cumulative mark-to-market change in the value of the swap. The prudential regulators noted in the preamble that the pricing sources and methodology used to determine such mark-to-market change is left to the agreement of the parties.

Both initial and variation margin must be exchanged on each business day beginning with T+1. Covered swap entities are permitted to adopt a minimum transfer amount of up to \$500,000 of combined initial margin and variation margin exposure.

For swaps between a covered swap entity and a financial end user, the Final Rule permits both initial and variation margin to be posted in immediately available cash

funds denominated in any major currency (or the settlement currency). The parties may also exchange certain types of non-cash eligible collateral, subject to a fixed haircut based on asset class. An additional 8-percent haircut is applied for non-cash variation margin denominated in a currency other than the currency of settlement. Initial margin denominated in a currency other than the currency of settlement is similarly subject to an 8-percent cross-currency haircut, except where it is the termination currency identified in an eligible master netting agreement between the parties (as further described in this article).

Initial Margin Segregation

Generally, initial margin collected and posted by covered swap entities must be held by a non-affiliate third-party custodian.¹² The covered swap entity is required to have a custodial agreement that prohibits rehypothecation, which need not be a tri-party custody agreement with the counterparty. The regulators left this open as a point to be negotiated in the market. Managers of funds with a material swaps exposure may want to document this as a tri-party relationship in order to maximise access to the accounts in the event of the dealer’s bankruptcy.

The Final Rule imposes a limitation on the ability of parties to post initial margin with a custodian in the form of cash. For cash to be considered eligible collateral, it must consist of “immediately available cash funds.” However, it is impractical for custodian banks to hold cash in the name of the posting party, and current business practice is for custodians to accept funds as a general deposit. Because of this, counterparties posting cash as initial margin must direct the custodian to reinvest the cash into eligible non-cash collateral within a reasonable time period after posting, taking into account relevant haircuts for non-cash collateral.

Eligible Master Netting Agreement

The Final Rule generally permits parties to an eligible master netting agreement (“EMNA”) to calculate initial margin or variation margin requirements on an aggregate net

basis across all non-cleared swaps.¹³ In order to qualify as an EMNA, a master netting agreement must meet certain requirements, such as the absence of a walkaway clause permitting a non-defaulting counterparty to make a reduced payment following a default. A covered swap entity intending to rely on an EMNA is required by the terms of the Final Rule to conduct sufficient legal review in light of the relevant jurisdictions to satisfy itself of the enforceability of the EMNA in the event of a party’s insolvency.

A portfolio of swaps under an EMNA entered into prior to the applicable compliance date will not be subject to the requirements of the Final Rule. However, including a non-cleared swap in a netting portfolio following the compliance date will subject the entire portfolio to the margin rules. Covered swap entities are permitted to create separate netting portfolios under a single EMNA so that the parties may maintain a separate set of legacy swaps that will not be subject to the margin rules. As such, parties to an ISDA master agreement that meets the requirements of an EMNA may want to consider maintaining a separate portfolio of legacy swaps if they wish to exempt such trades from the Final Rule’s requirements. This will likely entail separate credit support annexes for each portfolio.

Documentation Requirements

Covered swap entities are required to execute swap documentation enabling them to collect and post margin in accordance with the Final Rule. The documentation must also specify the methods, procedures, rules and inputs for determining the value of each non-cleared swap for purposes of calculating variation margin and resolving disputes, and it must also include a description of the initial margin methodology.¹⁴ Existing credit support annexes will need to be amended accordingly, and such amendments may or may not be adopted by the industry as part of a new ISDA protocol.

Cross-Border Applicability

The Final Rule does not apply to a foreign non-cleared swap of a foreign covered swap

entity. A “foreign non-cleared swap” is defined to mean a non-cleared swap between two counterparties, neither of which is (1) organised under the laws of any state in the United States, (2) a branch or office of an entity organised in the United States, or (3) a swap entity that is a subsidiary of an entity organised in the United States. This bright-line rule provides that an offshore investment fund will not be considered a US person for purposes of determining the applicability of the margin requirements to a particular swap. This significantly differs from the CFTC “US person” definition, which requires analysis of an entity’s principal place of business and includes many offshore investment funds managed by US-based fund managers. Regardless, a swap between a covered swap entity and an offshore investment fund will be subject to the requirements of the Final Rule.

Compliance Dates

Compliance dates for initial margin requirements range from 1 September 2016 through 1 September 2020, depending on the average daily notional amount of non-cleared swaps for the relevant covered swap entity and its counterparty.¹⁵ The variation margin requirements begin 1 September 2016 for swaps between covered swap entities and counterparties that each have average daily notional amounts of non-cleared swaps exceeding \$3 trillion. Swaps between all other covered swap entities and counterparties are subject to a 1 March 2017 compliance date for the variation margin requirements. **THFJ**

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FOOTNOTES

1. See Final Rule to Establish Margin and Capital Requirements for Covered Swap Entities (unofficial text) (the “Final Rule”). The Final Rule was jointly adopted by the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Farm Credit Administration and the Federal Housing Finance Agency. For ease of reference, the term “swaps” as used herein will refer to both “swaps” and “security-based swaps” unless the context requires otherwise.
2. See Final Rule, at 5 n.4. Although the buy-side is generally not directly subject to the Final Rule, the requirements are imposed on all swaps entered into by a covered swap entity, and thus investment funds trading swaps with any covered swap entity will be impacted.
3. See 7 U.S.C. § 6s(e)(2)(A); § 15 U.S.C. 78o-10(e)(2)(A).
4. See Margin and Capital Requirements for Covered Swap Entities, 79 Fed. Reg. 57348 (Sept. 24, 2014) (the “proposed rule”).
5. See Basel Committee on Banking Supervision & Board of the International Organisation of Securities Commissions, Consultative Document: Margin Requirements for Non-Centrally-Cleared Derivatives (September 2013).
6. The calculation includes non-cleared swaps, non-cleared security-based swaps, foreign exchange forwards and foreign exchange swaps.
7. Where the assets of an investment fund are consolidated with the assets of its investment manager, such as during seeding, the entities would be considered affiliated for purposes of the Final Rule. Additionally, despite several requests from commenters, the regulators elected not to adopt a rule that would treat separately managed accounts of a single entity investment fund or pension fund as separate and distinct entities.
8. In order to determine the amount of initial margin a covered swap entity must post to a counterparty, the Final Rule provides that such amount must not be less than the amount of initial margin that it would be required to collect if the covered swap entity were in the place of the counterparty.
9. The Final Rule’s margin provisions represent only minimum requirements and do not prohibit covered swap entities from collecting initial margin in excess of what is required under the Final Rule.
10. In such situations, a covered swap entity is directed by the Final Rule to collect margin at such times and in such forms and amounts (if any) as it deems appropriate in its overall credit risk management.
11. The Final Rule recognises the following four asset classes: (1) commodity, (2) equity, (3) credit, and (4) foreign exchange and interest rate.
12. When a covered swap entity collects initial margin from a counterparty, the Final Rule obligates the covered swap entity to segregate only the amount of margin required to be collected under the rule. To the extent a covered swap entity collects initial margin in excess of the minimum amount required, it is permitted to hold and use such collateral pursuant to the terms of its credit support documentation.
13. Some exceptions to note: (1) Initial margin and variation margin may not be netted against one another; (2) a covered swap entity is not permitted to net initial margin amounts that it is required to post to a counterparty against initial margin amounts that it is required to collect from such counterparty; and (3) non-cleared swaps subject to the Final Rule may not be netted against any other products under an EMNA aside from other non-cleared swaps.
14. These documentation requirements are more burdensome than the documentation requirements imposed by the CFTC’s external business conduct rules, which the buy-side largely incorporated by adhering to the ISDA March 2013 Dodd-Frank Protocol. See 17 C.F.R. § 23.504 (Swap Trading Relationship Documentation).
15. Affiliates are included for purposes of calculating a party’s daily aggregate notional amount.