

## Swap Dealers Will Face Significant Challenges from Reproposed Margin Rules for Uncleared Swaps

***Dealers and major industry participants may be subject to new margin requirements beginning as early as December 1, 2015.***

Regulators are expected to finalize rules regarding margin requirements for uncleared swaps shortly. The Prudential Regulators<sup>1</sup> re-proposed rules regarding margin requirements for uncleared swaps<sup>2</sup> on September 3, 2014 (the Prudential Regulator Proposed Margin Rules),<sup>3</sup> which would apply to swap dealers, security-based swap dealers, major swap participants and major security-based swap participants that are subject to supervision by the Prudential Regulators (collectively, PR Covered Swap Entities). The Commodity Futures Trading Commission (CFTC) followed with its own reproposal on October 3, 2014 (the CFTC Proposed Margin Rules<sup>4</sup> and together with the Prudential Regulator Proposed Margin Rules, the Proposed Margin Rules), which would apply to swap dealers and major swap participants that are not subject to the jurisdiction of the Prudential Regulators (CFTC Covered Swap Entities and together with the PR Covered Swap Entities, the Covered Swap Entities). Both rules are substantially similar. The new Proposed Margin Rules would modify significantly the original proposals<sup>5</sup> to reflect the international standards issued in 2013 by the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO), which established the international framework for uncleared margin rules.<sup>6</sup> The comment period for the Proposed Margin Rules closed at the end of 2014.

Most notably, the Proposed Margin Rules:

- Require posting and collecting of variation margin for all swaps<sup>7</sup> entered into between Covered Swap Entities and (i) other Covered Swap Entities or (ii) financial end users
- Require posting and collecting of initial margin for all swaps entered into between Covered Swap Entities and (i) other Covered Swap Entities or (ii) financial end users with a “material swaps exposure” (*i.e.*, an average daily aggregate notional amount of uncleared swaps in excess of US\$3 billion, as discussed further below)
- Do not require a Covered Swap Entity to post or collect initial or variation margin for uncleared swaps entered into with non-financial end users
- Significantly revise the definition of “financial end user”
- Require Covered Swap Entities to post and collect margin for uncleared swaps entered into with affiliates

- Permit Covered Swap Entities to use internal models or standard look-up tables for initial margin
- Require Covered Swap Entities to segregate with an independent custodian all initial margin collected
- Limit eligible collateral for variation margin to cash
- Set forth a proposal for cross-border application of margin requirements

The comment periods for the re-proposed rule set recently closed. While finalization of the rules is expected by early 2015, the industry remains concerned with various aspects of the rules, including the compressed timeline for compliance, the liquidity constraints that such rules will trigger, and the need to ensure international harmonization and a coherent cross-border application of the final rules.

This Client Alert discusses the Proposed Margin Rules and summarizes the major industry concerns regarding the proposals.

## **Initial and Variation Margin Requirements<sup>8</sup>**

As noted above, Covered Swap Entities entering into uncleared swaps with other Covered Swap Entities or with financial end users with a material swaps exposure must collect and post initial and variation margin on a daily basis. Covered Swap Entities facing a financial end user that does not have a material swaps exposure would be required to collect and post daily variation margin but would not need to collect or post initial margin. Margin would not be required for transactions with commercial end users.

The term “financial end user” is based on the term “financial entity,” which is used to define the scope of the clearing rules. However, the proposed term “financial end user” is much more specific, and would include:

- Bank holding companies (and their affiliates)
- Savings and loan holding companies
- Nonbank financial institutions supervised by the Board of Governors of the Federal Reserve System under Title I of the Dodd-Frank Act
- Depository institutions, foreign banks
- Federal or state credit unions
- State-licensed or registered credit or lending entities
- Broker-dealers
- Money services business (including a check casher, money transmitter, currency dealer or exchange or money order or traveler’s check issuer)
- Registered investment companies
- Real estate investment companies
- Investment advisers
- Securities holding companies
- Business development companies
- Private funds
- Private mortgage REITs
- Securitization vehicles
- Commodity pools
- Commodity pool operators
- Commodity trading advisors
- Futures commission merchants

- Employee benefit plans
- Insurance companies
- Cooperatives that are financial institutions
- An entity that is, or holds itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in loans, securities, swaps, funds or other assets for resale or other disposition or otherwise trading in loans, securities, swaps, funds or other assets
- A foreign entity that would be considered a financial end user if it were organized in the US
- Any other entity that the CFTC or the Prudential Regulators determine should be treated as a financial end user

The term “financial end user” does **not** include:

- A sovereign entity
- A multilateral development bank
- The Bank for International Settlements
- An entity that is exempt from the definition of financial entity under Section 2(h)(7)(C)(iii) of the Commodity Exchange Act (CEA)
- An affiliate that qualifies for the clearing exemption under Section 2(h)(7)(D) of the CEA<sup>9</sup>

Under the Proposed Margin Rules, a financial end user would be considered to have a “material swaps exposure” if such entity and its affiliates, in the aggregate, have an average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange forwards and foreign exchange swaps with all counterparties for June, July and August of the previous calendar year that exceeds US\$3 billion (calculated only for business days).

Although neither set of the Proposed Margin Rules expressly requires Covered Swap Entities to collect or post initial or variation margin when such entities enter into uncleared swaps with counterparties who are neither Covered Swap Entities nor financial end users, the approaches of the CFTC and the Prudential Regulators differ slightly. The Prudential Regulator Proposed Margin Rules provide that Covered Swap Entities transacting with non-financial end users must collect such initial and variation margin that the Covered Swap Entity deems necessary to address the counterparty credit risk and inherent risks in uncleared swaps. The CFTC Proposed Margin Rules provide that Covered Swap Entities must calculate hypothetical initial margin and variation margin when transacting with a non-financial end user with a material swaps exposure as if such counterparty were a Covered Swap Entity or financial end user and compare that amount to any initial margin required under the relevant margin documentation. All such determinations would be subject to review by the CFTC or the Prudential Regulators, as applicable.

## **Initial Margin Calculation and Requirements<sup>10</sup>**

The Proposed Rules include a US\$65 million threshold below which margin would not be required to be collected (minimum threshold amount). Such minimum threshold amount would be calculated by taking into account the aggregate credit exposure of all uncleared swaps between a Covered Swap Entity and its affiliates, and a counterparty and its affiliates.

Covered Swap Entities would be required to calculate the initial margin utilizing an approved internal margin model or in accordance with a standardized margin schedule. Entities wishing to use initial margin models must obtain prior approval from the relevant Prudential Regulator or the CFTC, as applicable, before using such model to calculate initial margin. The initial margin model must satisfy certain qualitative criteria set forth in the Proposed Margin Rules and must establish certain minimum control,

oversight and validation mechanisms.<sup>11</sup> In particular, the initial margin model must determine the potential future exposure of a swap or netting set of swaps, where the potential future exposure is an estimate of the one-tailed 99 percent confidence interval for an increase in the value of the swap or netting set over a 10-business-day period (or until the maturity of the swap, if earlier). The model may reflect offsetting exposures, diversification and other hedging benefits for uncleared swaps that are governed by an eligible master netting agreement, *provided* that the Covered Swap Entity demonstrates the reasonableness for modeling and measuring such hedging benefits. Moreover, with respect to uncleared cross-currency swaps, the initial margin model does not need to recognize risks or risk factors associated with the FX swap — the fixed, physically-settled exchange of principal — embedded in the uncleared cross-currency swap. But the model must recognize all material risks associated with all other payments and cash flows of the cross-currency swap.

To the extent that uncleared swaps are executed pursuant to an eligible master netting agreement between the Covered Swap Entity and a financial end user or another Covered Swap Entity, the Covered Swap Entity may use its initial margin model to calculate and comply with initial margin requirements on an aggregate basis. If the netting agreement covers swaps entered into before the applicable compliance date for the margin requirements, those swaps must be included for purposes of calculating and complying with initial margin requirements — effectively imposing a retroactive margin requirement on those swaps.

## Variation Margin Calculation and Requirements<sup>12</sup>

Under the CFTC Proposed Margin Rules, variation margin would need to be calculated by reference to recent trades, third-party valuation, or other objective criteria. The Prudential Regulator Proposed Margin Rules do not prescribe a specific method of calculation. Both retain the meaning of variation margin as the mark-to-market change in the value to the Covered Swap Entity of a swap measured from the date such swap is entered into with the other counterparty. Variation margin would be required to be posted at least daily. As with initial margin, if an eligible master netting agreement governs the uncleared swaps for which variation margin must be calculated, the Covered Swap Entity may calculate variation margin on an aggregate basis, provided all uncleared swaps governed by such agreement are included, even if such uncleared swaps were entered into prior to the compliance date for the margin requirements.

A summary of the initial and variation margin collection and posting requirements is set forth below:

	CSE Required to Collect and Post Initial Margin?	CSE Required to Collect and Post Variation Margin?
<b>COUNTERPARTY OF COVERED SWAP ENTITY (CSE)</b>		
Covered Swap Entity	Yes	Yes
Financial End User with Material Swaps Exposure	Yes	Yes
Financial End User without Material Swaps Exposure	No	Yes
Non-Financial End User	No	No

Note, as mentioned above, the Proposed Margin Rules do not exempt uncleared swap transactions between a Covered Swap Entity and its affiliates. The proposal would require posting and collection of margin in inter-affiliate trades even in circumstances in which this would not be required under existing banking rules regarding inter-affiliate transaction, and may undermine the utility of exemptions from clearing for inter-affiliate swaps.

## **Minimum Transfer Amount**

The Proposed Rules propose a US\$650,000 minimum transfer amount for all margin which the Covered Swap Entity would be required to post or collect.

## **Satisfying Collecting and Posting Requirements**

Because the statutory authority does not allow the regulatory authorities to impose regulatory requirements on entities that are not Covered Swap Entities, the rules impose a collection obligation on Covered Swap Entities rather than a posting obligation on their unregulated counterparties. The Proposed Rules further provide that a Covered Swap Entity will not be deemed to have violated its obligation to collect or post margin from or to a counterparty if (1) the counterparty has refused or failed to provide or accept the required margin to or from the Covered Swap Entity and (2) the Covered Swap Entity has made the necessary efforts to collect or post the required margin or has demonstrated to the relevant regulatory authority that it has made appropriate efforts to collect or post the required margin.

## **Acceptable Collateral and Segregation of Collateral<sup>13</sup>**

The forms of collateral that may be posted as initial margin vary slightly between the Proposed Rules, but generally include:

- Cash
- Debt securities issued or guaranteed by the US Department of Treasury or another agency
- Debt securities issued or guaranteed by the European Central Bank, the International Monetary Fund, multilateral development banks or the Bank for International Settlements
- Certain US government-sponsored debt
- Certain debt issued by sovereign entities
- Certain corporate debt securities
- Certain listed equities
- Gold

Such collateral would be subject to haircuts between 0-25 percent in accordance with a schedule under the Proposed Rules.

A Covered Swap Entity would be required to hold initial margin (and with respect to the Prudential Regulator Proposed Margin Rules, all margin other than variation margin) in a segregated account with an unaffiliated custodian. Any collateral posted by a Covered Swap Entity as initial margin (and with respect to the Prudential Regulator Proposed Margin Rules, all margin other than variation margin) would also be required to be segregated with an unaffiliated custodian.<sup>14</sup> The custodian would be prohibited from rehypothecating, repledging or otherwise transferring (through securities lending, repurchase agreement, reverse repurchase agreement or otherwise) such funds held in the custodial account.

Variation margin is not required to be segregated or held by an unaffiliated custodian and must be posted in cash denominated in US dollars or the currency in which payment obligations under the swap are required to be settled.

Any amounts posted or collected outside of the minimum requirements of the Proposed Rules would be acceptable in any form agreed to by the parties.

## **Documentation<sup>15</sup>**

Consistent with existing CFTC rules requiring swap dealers to enter into written documentation with their counterparties for all bilateral swaps, Covered Swap Entities will be required to document the margin requirements applicable to their swap transactions. Generally the documentation must specify (1) the methodology and data sources used to calculate initial margin, variation margin, the value of collateral and the value of uncleared swaps, (2) procedures for resolving disputes regarding valuations or margin amounts, and (3) thresholds below which initial margin and variation margin need not be posted and/or paid. Although earlier documentation requirements have been addressed largely through implementation of industry protocols that allowed large numbers of agreements to be amended in an expedited and standardized manner, whether market participants will be willing to sign on to industry protocols in the context of margin remains unclear.

## **Cross-Border Application**

The Prudential Regulators expressly provide in their respective margin rules that the requirements do not apply to foreign uncleared swaps.<sup>16</sup> Additionally, the Prudential Regulators provide a mechanism by which prudentially-regulated Covered Swap Entities may ask for a substituted compliance determination in respect of certain uncleared swaps. Covered Swap Entities may request such a determination if the obligations under the uncleared swap are not guaranteed by a US entity and the Covered Swap Entity is itself a foreign Covered Swap Entity, a foreign bank or a US branch or agency of a foreign bank or a foreign subsidiary of a depository institution, Edge corporation or agreement corporation. In making the determination, the Prudential Regulators would consider whether the requirements of such foreign regulatory framework for uncleared swaps were comparable to the applicable margin requirements. Covered Swap Entities receiving a substituted compliance determination would satisfy their requirements under the margin rules by compliance with the foreign regulatory framework.

The CFTC Proposed Margin Rules do not propose a specific approach to the cross-border application of the proposed margin requirements, but instead include an advance notice of proposed rulemaking requesting comment on three potential alternative approaches to the cross-border application of the margin rules. The first alternative would propose a “transaction-level” approach that would be consistent with the CFTC Cross-Border Guidance<sup>17</sup>. Under this alternative, the proposed margin requirements would apply to US Covered Swap Entities (other than a foreign branch of a US bank that is a Covered Swap Entity) irrespective of whether the counterparty is a US person or not, without substituted compliance. The second alternative would mirror the Prudential Regulator Proposed Margin Rules. The third alternative would propose an “entity-level” approach where the CFTC would apply its cross-border margin rules on an entity-wide level, irrespective of whether the counterparty is a US person, but would consider allowing substituted compliance where appropriate.

## **Compliance Would Be Phased-In for Swaps Entered into on or After December 1, 2015<sup>18</sup>**

Variation margin would be required for all Covered Swaps entered into on or after December 1, 2015.

The initial margin requirements would be phased-in for Covered Swaps entered into on or after the applicable compliance date listed below, if each of the Covered Swap Entities and its counterparty (in each case combined with their respective affiliates) has an average daily aggregate notional amount of

uncleared swaps, uncleared security-based swaps, foreign exchange forwards and foreign exchange swaps (computed for business days only) in the amounts and for the periods set forth below:

	Variation Margin Compliance Date	Initial Margin Compliance Date
<b>AVERAGE DAILY AGGREGATE NOTIONAL AMOUNT</b>		
Exceeding US\$4 trillion in June, July and August of 2015	Dec. 1, 2015	Dec. 1, 2015
Exceeding US\$3 trillion in June, July and August of 2016	Dec. 1, 2015	Dec. 1, 2016
Exceeding US\$2 trillion in June, July and August of 2017	Dec. 1, 2015	Dec. 1, 2017
Exceeding US\$1 trillion in June, July and August of 2018	Dec. 1, 2015	Dec. 1, 2018
Any amount	Dec. 1, 2015	Dec. 1, 2019

Although the Proposed Margin Rules do not explicitly apply to Covered Swaps entered into before the applicable compliance date, as noted above, such swaps may be effectively included within the rules to the extent that they are subject to a master netting agreement that will continue to be used after the compliance date.

## Industry Response

The impact that the margin requirements will have on the derivatives market and the strain the requirements will place on the market participants' liquidity are of ongoing concern to the industry.

Generally, the comment letters the regulators have received from trade associations, other industry groups and other market participants have voiced concerns over the implementation timeline, which would require variation margin for all Covered Swap Entities and initial margin for certain Covered Swap Entities to be exchanged beginning December 1, 2015. In particular, once the rules become finalized, Covered Swap Entities will need to build out the legal, operational, risk management and technological enhancements necessary to effectively implement the initial and variation margin requirements and will need to enter into segregation agreements related to initial margin. Moreover, Covered Swap Entities will need time to build out and receive approvals for their initial margin models. Market participants have asked for more time to be able to comply with the requirements.

Further, the industry has argued that the Proposed Margin Rules may *increase* systemic risk by unnecessarily draining liquidity from the financial system and, alternatively, by discouraging hedging where the costs of exchanging margin are too great, or the logistical challenges inherent in daily variation margin exchange are unworkable. The margin requirements to be applied to inter-affiliate swaps involving a Covered Swap Entity are of particular concern. So, too, are provisions that would apply these rules to securitizations in ways that may be inconsistent with the ability to obtain the required ratings necessary for the transaction.

Finally, the industry is urging the regulators to finalize rules with an internationally harmonized approach by minimizing differences as between foreign jurisdictions. Without such a coordinated and harmonized

rule set, the Proposed Margin Rules, if finalized in their current form, may move business offshore to other jurisdictions with less stringent rules.

While the industry remains concerned over the rules, the rules are expected to be finalized early 2015. Regulators may still address and revise the rules in response to the comments received by the industry.

---

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

**[Carlos Alvarez](#)**

carlos.alvarez@lw.com  
+1.212.906.1269  
New York

**[Loren N. Finegold](#)**

loren.finegold@lw.com  
+1.212.906.1327  
New York

**[Ellen L. Marks](#)**

ellen.marks@lw.com  
+1.312.876.7626  
Chicago

**[Peter Y. Malyshev](#)**

peter.malyshev@lw.com  
+1.202.637.1087  
Washington, D.C.

**[Yvette D. Valdez](#)**

yvette.valdez@lw.com  
+1.212.906.1797  
New York

**[Brett M. Ackerman](#)**

brett.ackerman@lw.com  
+1.202.637.2109  
Washington, D.C.

**[Sean R Miller](#)**

sean.miller@lw.com  
+1.212.906.4685  
New York

**You Might Also Be Interested In**

[The New 2014 ISDA Credit Derivatives Definitions](#)

[CFTC Staff Issues Relief from Ownership and Control Reporting Rules](#)

[Updated: CFTC FORM 40/40S Reporting Requirements](#)

[SEC Proposed Rules: Recordkeeping and Reporting for SBSDs, MSBSPs and BDs;  
Capital Rules for Certain SBSDs](#)

---

*Client Alert* is published by Latham & Watkins as a news reporting service to clients and other friends. The information contained in this publication should not be construed as legal advice. Should further analysis or explanation of the subject matter be required, please contact the lawyer with whom you normally consult. The invitation to contact is not a solicitation for legal work under the laws of any jurisdiction in which Latham lawyers are not authorized to practice. A complete list of Latham's *Client Alerts* can be found at [www.lw.com](http://www.lw.com). If you wish to update your contact details or customize the information you receive from Latham & Watkins, visit <http://events.lw.com/reaction/subscriptionpage.html> to subscribe to the firm's global client mailings program.

## Endnotes

---

- <sup>1</sup> "Prudential Regulators" means, collectively, the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency.
- <sup>2</sup> For simplicity, "uncleared swaps" generally refers collectively to uncleared "swaps" and "security-based swaps" as jointly defined by the CFTC and SEC. We occasionally mention security-based swaps specifically to clarify a calculation or threshold.
- <sup>3</sup> See Margin and Capital Requirements for Covered Swap Entities, 79 Fed. Reg. 57348 (Sept. 24, 2014), hereinafter referred to as the "Prudential Regulator Proposed Margin Rules."
- <sup>4</sup> See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 Fed. Reg. 59898 (Oct. 3, 2014), hereinafter referred to as the "CFTC Proposed Margin Rules."
- <sup>5</sup> See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 FR 23732 (April 28, 2011) and Margin and Capital Requirements for Covered Swap Entities, 76 FR 27564 (May 11, 2011).
- <sup>6</sup> BCBS/IOSCO, Margin requirements for non-centrally cleared derivatives (September 2013).
- <sup>7</sup> For purposes of this Client Alert, the term "swaps" shall include "swaps" and "security-based swaps" unless indicated otherwise.
- <sup>8</sup> See Sections \_\_.3 and \_\_.4 of the Prudential Regulator Proposed Margin Rules at 57390 and Section 23.151 of the CFTC Proposed Margin Rules at 59927.
- <sup>9</sup> See Section \_\_.2 of the Prudential Regulator Proposed Margin Rules at 57391-57392 and Sections 23.152 and 23.153 of the CFTC Proposed Margin Rules at 59928.
- <sup>10</sup> See Section \_\_.8 of the Prudential Regulator Proposed Margin Rules at 57393-57395 and Section 23.154 of the CFTC Proposed Margin Rules at 59929-59931.
- <sup>11</sup> See Section \_\_.8 of the Prudential Regulator Proposed Margin Rules at 57393 and Section 23.154(b)(3)(i) of the CFTC Proposed Margin Rules at 59929.
- <sup>12</sup> See Section \_\_.4 of the Prudential Regulator Proposed Margin Rules at 57392 and Section 23.155 of the CFTC Proposed Margin Rules at 59931.
- <sup>13</sup> See Sections \_\_.6 and \_\_.7 of the Prudential Regulator Proposed Margin Rules at 57392-57393 and Sections 23.156 and 23.157 of the CFTC Proposed Margin Rules at 59931-59932.
- <sup>14</sup> The CFTC Proposed Margin Rules do not explicitly state whether initial margin posted or collected in excess of the margin requirements would be required to be segregated as well. The Prudential Regulator Proposed Margin Rules clearly capture this excess.
- <sup>15</sup> See Section \_\_.10 of the Prudential Regulator Proposed Margin Rules at 57395 and Section 23.158 of the CFTC Proposed Margin Rules at 59932.
- <sup>16</sup> A foreign uncleared swap includes any uncleared swap where neither the counterparty nor any guarantor is (i) a US entity or any US branch, office, agency or subsidiary of a non-US entity or (ii) controlled by a US entity.
- <sup>17</sup> Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations, 78 FR 45292 (July 26, 2013).
- <sup>18</sup> See Section \_\_.1 of the Prudential Regulator Proposed Margin Rules at 57388-57389 and Section 23.159 of the CFTC Proposed Margin Rules at 59932-59933.