Clients&FriendsMemo

Summary of Prudential Regulators' Re-Proposed Margin Rules

September 4, 2014

On September 3, the Board of Governors of the Federal Reserve System ("**Board**"), the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Farm Credit Administration and the Federal Housing Finance Agency (collectively, the "**Prudential Regulators**") voted to re-propose rules to implement Sections 731 and 764 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank**") (a draft of which has been published online – the "**Draft Proposal**").[1] The Draft Proposal would impose initial and variation margin requirements on prudentially regulated swap dealers, security-based swap dealers, major swap participants and major security-based swap participants ("**Covered Swap Entities**") entering into uncleared swaps and security-based swaps.

As expected, the Draft Proposal varies substantially from an earlier 2011 proposal and largely tracks standards recommended by G-20 regulators under the joint auspices of the Basel Committee on Banking Supervision ("**BCBS**") and the International Organization of Securities Commissions ("**IOSCO**") in September 2013.[2] In particular, the Draft Proposal implements the BCBS-IOSCO recommendation to require two-way posting of both initial and variation margin by requiring Covered Swap Entities to both collect and post initial and variation margin with certain counterparties under specified circumstances. To this end, the Draft Proposal provides new terms defining "financial end users" and "other counterparties" and generally limits the mandatory margin requirements to situations where a Covered Swap Entity faces a financial end user or another swap dealer or MSP.

The Draft Proposal is the third proposal from a major financial jurisdiction to implement margin requirements for derivatives based on the BCBS-IOSCO Framework, the other two proposals

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1 *See* Draft Federal Register Notice – Margin and Capital Requirements for Covered Swap Entities, *available at* http://www.federalreserve.gov/aboutthefed/boardmeetings/20140903openmaterials.htm. The Board also posted a Staff memorandum outlining the Draft Proposal ("**Board Summary**").

2 *Margin Requirements for Non-centrally Cleared Derivatives* (September 2013), *available at* http://www.bis.org/publ/bcbs261.htm ("**BCBS-IOSCO Framework**" or "**Framework**").

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being that of the European Union and of Japan.[3] A draft of the rulemaking has been posted to the Board website. Comments on the Draft Proposal will be due 60 days following the date on which it is published in the Federal Register.

Below is a brief summary of key points based on an early review of the Draft Proposal, with notes highlighting areas where the Draft Proposal appears to differ from the EU Margin RTS in important respects.

Scope of Rule Coverage

Parties:

- Directly Regulated Entities. As discussed above, the rules would apply to Covered Swap Entities when they face certain counterparties. While the counterparties themselves may not be directly subject to margin regulation under Dodd-Frank, Covered Swap Entities would be required to both collect and post initial and variation margin when facing certain counterparties.
- Types of Counterparties, Generally. The Draft Proposal generally would group swaps market participants into four types: (i) Covered Swap Entities; (ii) financial end users with "material swaps exposure" (iii) financial end users without "material swaps exposure" and (iv) "other counterparties" (*i.e.*, none of the above). As described in greater detail below, initial margin requirements generally would apply to the counterparties within the first two groups, while variation margin requirements generally would apply for counterparties in the first three groups.
    - "Financial end user" is a new definition primarily based on well-established status types under various other U.S. regulations (though non-U.S. entities must determine if they would qualify if they operated in the United States). It is not defined with reference to the definition of "financial entity" in Section 2(h) of the CEA. The new definition (i) enumerates types of financial market participants, (ii) excludes sovereign entities, multilateral development banks and the Bank for International Settlements, and (iii) excludes certain entities (*e.g.*, finance affiliates) that are specially exempted or excluded from mandatory clearing pursuant to CEA Section 2(h)(7)(C)(iii) or (D).
    - "Material swaps exposure" is defined to mean a consolidated daily average notional amount (for the counterparty and all "affiliates") of open, uncleared swaps, security-based swaps, FX forwards and FX swaps with all counterparties, for June through August of the previous calendar year, of over $3 billion.

[3] *See* Draft Regulatory Technical Standards on Risk-Mitigation Techniques for OTC-Derivative Contracts Not Cleared by a CCP Under Article 11(15) of Regulation (EU) No 648/2012 (April 14, 2014) ("**EU Margin RTS**") and Draft amendments to the "Cabinet Office Ordinance on Financial Instruments Business" and "Comprehensive Guidelines for Supervision" with regard to margin requirements for non-centrally cleared derivatives (July 3, 2014) (Japanese proposal).

Products:

- Swaps. The Draft Proposal would apply to all swaps and security-based swaps.
- FX Products. Foreign exchange swaps and foreign exchange forwards that are not deemed to be swaps as a result of the Treasury determination pursuant to CEA Section 1a(47) are not subject to the margin requirements, but are considered for purposes of determining an entity's swaps exposure for determining whether such an entity is subject to initial margin requirements.[4]

CWT Comments:
The Draft Proposal provides some welcome relief to non-financial end users by (i) simplifying and clarifying the line between financial and non-financial end users and (ii) providing non-financial end users a broader carve-out than proposed in 2011. With that said, the scope provisions are still complex. Perhaps more importantly, they differ from the European Margin RTS along a number of dimensions. These inconsistencies will impose substantial burdens on market participants who trade across national borders, and may lead to market fragmentation.

The treatment of FX products could also lead to some arguably odd results. For example, an entity that enters into a small amount of "swaps" but a large amount of Treasury-exempted FX products could become subject to the initial margin requirements on an accelerated basis.

Implementation

- Variation Margin: Consistent with the BCBS-IOSCO Framework, the proposed compliance date for two-way posting of variation margin is December 1, 2015 for all Covered Swap Entities.
- Initial Margin: Initial margin requirements would be phased in over a five-year period, based on each party's (and such party's affiliates') consolidated average daily aggregate open notional amount of swaps, security-based swaps and exempted FX transactions, from June through August of each year. During each year of the phase-in, the threshold decreases as follows:
  - December 1, 2015: $4 trillion average notional from June through August 2015.
  - December 1, 2016: $3 trillion average notional from June through August 2016.
  - December 1, 2017: $2 trillion average notional from June through August 2017.
  - December 1, 2018: $1 trillion average notional from June through August 2018.
  - December 1, 2019 and beyond: $3 billion in average notional from June through August of that year.
  - Initial margin requirements would apply in the first year in which both parties to a trade have exceeded the relevant threshold for that year. For purposes of this calculation, each party

[4] The Draft Proposal also includes different treatment for "cross-currency swaps." Such transactions are counted only in part for purposes of initial margin requirements.

would be required to aggregate open transactions of all "affiliates," which would include any company that controls, is controlled by, or is under common control with, the entity.[5]

CWT Comments:

The compliance dates are broadly consistent with the Framework and the EU Margin RTS.[6] However, the threshold for application of initial margin requirements after 2019 is substantially lower ($3 billion vs. EUR 8 billion) than in the EU Margin RTS. In addition, the calculation that will be required under these rules would differ from the calculation that would be required under the EU Margin RTS as (i) the phase-in for initial margin requirements is based on dollars rather than euros, (ii) the scope of covered products differs (in particular with regard to OTC securities options) and (iii) the definition of "affiliates" differs somewhat from the analogous European definitions. If the relevant regulators fail to reconcile these differences in final rules, they are likely to materially increase the complexity of managing the transition, and could increase market fragmentation.

We also note that basing margin requirements on the consolidated activities of separate legal entities is likely to raise difficult issues of operational and strategic co-operation between entities that may be under common "control" for purposes of the relevant definition, but in fact operate independently and may not have identical ownership.

Finally, we note that the proposed compliance date for variation margin requirements is very aggressive and may be impractical as the Prudential Regulators (and their U.S. and non-U.S. counterparts) appear to be materially underestimating the logistical and documentational changes that will be required to implement these requirements.[7]

Variation Margin Requirements

- Scope. Variation margin requirements generally would apply to transactions where a Covered Swap Entity trades with either (i) another Swap Entity or (ii) a financial end user.

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[5] "Control" is defined for these purposes to be (i) ownership, control, or the power to vote 25% or more of a class of voting securities, (ii) ownership or control of 25% or more of total equity, or (iii) control of the election of a majority of directors or trustees.

[6] The Framework and EU Margin RTS call for a phase-in as follows: (i) 2015 - €3 trillion; (ii) 2016 - €2.25 trillion; (iii) 2017 - €1.5 trillion; (iv) 2018 - €0.75 trillion; and (v) 2019 and beyond - €8 billion. The Draft Proposal indicates that the lower amount to be used on a going-forward basis is due to a Board staff recommendation based on additional data and analyses that have been conducted since the Framework's publication. *See* Draft Proposal at 73-74 (requesting comment on the same).

[7] *See*, *e.g.*, Letter dated August 18, 2014 from the International Swaps and Derivatives Association, Inc. to the Basel Committee on Banking Supervision and the International Organization of Securities Commissions (addressing concerns relating to the December 2015 effective date), *available at* http://www2.isda.org/attachment/Njg5Nw==/WGMR%20MarginTiming%20final%2018082014%20(2).pdf.

  - Covered Swap Entities would be required to collect variation margin from counterparties that are not financial end users only if the Covered Swap Entity determines variation margin to be appropriate to address the credit risk posed by that counterparty and the risks of the relevant products.[8]

- Thresholds; Minimum Transfer Amounts. No threshold amounts would be allowed, but a minimum transfer amount of $650,000 would be allowed, with such minimum transfer amounts applying to initial and variation margin, combined.
- Timing. Variation margin would be required to be moved on a daily basis.
- Eligible Collateral. For variation margin, eligible collateral would be limited to U.S. dollars (eligible for all trades) or the currency in which the swap is denominated. No regulatory haircuts would be imposed on this limited list of eligible collateral.
- Segregation and Rehypothecation. Variation margin would not be required to be segregated at an independent third-party custodian and could be rehypothecated.
- Netting/Treatment of Historical Trades. Variation margin amounts for transactions under an eligible master netting agreement could be fully netted under the Draft Proposal. While historical trades would be grandfathered as a general matter, it appears that historical trades which are covered under a single eligible master netting agreement with new trades would be required to be margined under the new requirements.

CWT Comments:
While the Draft Proposal does not include a requirement to impose cross-currency haircuts on variation margin (which was proposed by the EU Margin RTS and is generally viewed by market participants as highly problematic), it does so at the cost of narrowly limiting the list of eligible collateral. Depending on final rules, this approach may create difficult conflicts when Covered Swap Entities face counterparties regulated in other jurisdictions.

In addition, the justification of the proposed treatment of historical trades is unclear as it would seem to disincentivize the use of master netting agreements. Nor is it clear that this requirement can be imposed as a practical matter, given that there is no requirement to segregate variation margin.

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[8] This formulation of the margin "requirement" applicable to end users was the Prudential Regulators' way of complying with the provisions of Dodd-Frank that, on the one hand, require swap dealers to collect margin, but, on the other hand, exempted certain end users from the requirement of posting margin. In short, the amount of margin that "must" be collected from end users may be zero.

Initial Margin Requirements

- Scope. The initial margin requirements would apply to transactions with (i) other Swap Entities and (ii) financial end users with material swaps exposure.
  - Covered Swap Entities would only be required collect initial margin from counterparties that are not financial end users if the Covered Swap Entity determines that collecting initial margin is necessary to address the credit risk posed by the counterparty and the risks of the relevant products.
- Thresholds. Covered Swap Entities would be permitted to apply thresholds up to $65 million. Thresholds would be applied on a consolidated basis, meaning each Consolidated Swap Entity and its affiliates would be required to allocate the threshold cap amongst all swap relationships with a relevant counterparty and its affiliates. Based on illustrations provided in the Draft Proposal, it appears that separate $65 million caps would apply to initial margin collected (on a consolidated basis) and posted.
- Timing. Initial margin must be posted or collected on a daily basis to reflect changes in portfolio composition or other factors that result in a change in initial margin amounts.
- Calculation. Initial margin may be calculated (i) using a standardized margin schedule or (ii) using an internal margin model that meets criteria specified in the proposed rule and approved by the relevant Prudential Regulator.
- Models would be required to be calculated with a view to capturing 99th percentile loss over a 10-day holding period.
- Eligible Collateral. Eligible collateral would be generally limited to “high-quality, liquid assets” (enumerated in the Draft Proposal) and subject to appropriate risk-based haircuts specified in Appendix B to the Draft Proposal.
- Segregation and Rehypothecation. Initial margin would be required to be segregated at an independent third-party custodian and could not rehypothecated.
- Netting/Treatment of Historical Trades. Given segregation requirements, it would not be possible to net initial margin collected or posted against other margin requirements. While historical trades are generally grandfathered from initial margin requirements, it appears that historical trades which are covered under a single eligible master netting agreement with new trades would be required to be margined under the new requirements, at least if an internal margin model is being used.

<u>CWT Comments</u>:
The Draft Proposal's list of eligible collateral types differs from that provided in the EU Margin RTS, as each set of regulations tends to privilege local assets. The approach to eligible collateral is also substantially simpler than that in the EU Margin RTS in several respects, including that (i) it would not generally impose an requirement to monitor external credit ratings or produce internal credit quality and/or volatility assessments to determine eligibility and haircuts (though the Farm Credit Administration and the Federal Housing Finance Agency would impose credit quality requirements), (ii) it would not impose concentration limits and (iii) it would employ a relatively simple approach to avoiding "wrong-way risk."

As with variation margin, the justification of the proposed treatment of historical trades is unclear and is likely to be a major disincentive to placing historical trades under the same bankruptcy netting agreement as new trades.

The questions of how thresholds will be allocated may also prove quite problematic, particularly in situations where affiliates are not under completely common ownership and operate, effectively, independently.

Cross-Border Implementation

- <u>Foreign Covered Swap Entities</u>. The Draft Proposal would not cover "foreign non-cleared swaps" of "foreign covered swap entities." Generally, "foreign non-cleared swaps" are non-cleared swaps where neither the counterparty nor any guarantor of either party is (i) organized under the laws of the United States or any State (including branches or subsidiaries of a foreign bank), (ii) a branch or office of an entity organized in the Unites States, or (iii) a Covered Swap Entity, that is controlled, directly or indirectly, by an entity that is organized under the laws of the United States or any State. A "foreign covered swap entity" is a covered swap entity that is not (i) organized under the laws of the United States or any State (including branches or subsidiaries of a foreign bank), (ii) a branch or office of an entity organized in the United States, or (iii) controlled directly or indirectly by an entity organized in the United States.
- <u>Substituted Compliance</u>. Substituted compliance may be available to a foreign covered swap entity, a non-U.S. bank, or a U.S. branch of a non-U.S. bank, where such entity is not guaranteed by an entity organized under the laws of the United States or any state.

<u>CWT Comments</u>:
An ongoing theme of implementing margin requirements for uncleared derivatives has been the need for, and the difficulties in achieving, regulatory consistency, or at least coordination, across jurisdictions. The Draft Proposal takes some steps towards this, but there continue to be inconsistencies and conflicts between the approaches taken by different jurisdictions. At the Board open meeting to discuss the Draft Proposal, Board governors and staff stressed that discussions between regulators across jurisdictions are ongoing and that the Board would look to

further discuss with their counterparts in other jurisdictions the responses received for the differing margin proposals.

We also note that the limited deference given to non-U.S. law may be problematic for subsidiaries of U.S. holding companies seeking to compete outside the United States if the subsidiary has a parent guarantee.

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Please feel free to contact the authors of this Clients & Friends Memo if you would like to discuss any of the issues covered herein.

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