

Clients & Friends Memo

CFTC Votes to Re-Propose Margin Requirements for Uncleared Swaps

September 18, 2014

On September 17, 2014, the Commodity Futures Trading Commission (“CFTC”) voted to re-propose rules to impose initial and variation margin requirements on uncleared swaps entered into by swap dealers and major swap participants that are not regulated by a “Prudential Regulator” (such entities, the “**Covered Swap Entities**”).¹ The CFTC vote comes two weeks after the Prudential Regulators voted to re-propose analogous rules for swap dealers and major swap participants under their jurisdiction (the “**PR Margin Proposal**”).² According to the discussion at the CFTC’s open meeting, the CFTC proposal – the text of which has not yet been made publicly available – is expected to be substantially similar to the PR Margin Proposal.

In particular, the CFTC staff and Commissioners indicated that the CFTC proposal would be parallel to the PR Margin Proposal in the following ways:

- Covered Swap Entities would be required to both post and collect variation margin in transactions with (i) other swap dealers and major swap participants and (ii) “financial end users” (*i.e.*, excluding “commercial” end users).³
- Covered Swap Entities would be required to both post and collect initial margin in transactions with (i) other swap dealers and major swap participants and (ii) “financial end users” that have over \$3 billion in gross notional exposure in uncleared swaps (which is significantly lower than the €8 billion used in the European Union’s margin proposal and under the G-20 framework).
- Variation margin would be required to be collected and posted exclusively in cash.

¹ “**Prudential Regulators**” means the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Farm Credit Administration and the Federal Housing Finance Agency.

² See Draft Federal Register Notice – Margin and Capital Requirements for Covered Swap Entities, *available at* <http://www.federalreserve.gov/aboutthefed/boardmeetings/20140903openmaterials.htm>.

Previously, we published a summary of the PR Proposal. See Cadwalader memorandum, “Summary of Prudential Regulators’ Re-Proposed Margin Rules” (Sept. 4, 2014), *available at* <http://www.cadwalader.com/resources/clients-friends-memos/summary-of-prudential-regulators-reproposed-margin-rules>.

³ It is not clear, based on the meeting, whether the CFTC will propose the same definition of “financial end user” as the Prudential Regulators.

- Initial margin could be collected and posted in various instruments, with such list to be matched to the PR Margin Proposal.
- Posted initial margin would be required to be segregated by an independent custodian and would not be allowed to be rehypothecated.
- Initial margin requirements could be based on models or a standardized table. Models would be required to use a 99% confidence interval over a 10-day liquidation period.
- Margin requirements would begin in December 2015, with initial margin requirements phased in over a five-year period.

Despite the substantial similarity to the PR Margin Proposal, a number of important questions were raised at the open meeting.

- Commissioner Wetjen asked whether initial margin could be held in an omnibus account. CFTC staff indicated their anticipation that, while individual margin would be required to be individually segregated, this was not specified in the proposal.
- Commissioner Wetjen also stressed the importance of the margin rules' close alignment with capital rules, stating that "the [CFTC] should consider implanting its capital rules in the near future and re-open the comment period for its margin proposal at that time."⁴
- Commissioner Wetjen questioned how "uncleared" would be defined, noting that some swaps could be "cleared" by entities that are not registered with the CFTC as derivatives clearing organizations.
- Commissioner Wetjen also questioned why the proposal would "reverse the judgment" made by the CFTC when it decided to exempt certain inter-affiliate swaps from the clearing mandate, noting that the proposal would require affiliates to post initial and variation margin for uncleared swaps.
- Commissioner Giancarlo questioned the approach used for initial margin models, suggesting that the CFTC should provide greater justification for the appropriateness of a 10-day liquidation period for all products.⁵
- Chairman Massad asked who would be responsible for approving initial models, noting limited CFTC resources. CFTC staff indicated that they would include requests for comment on this

⁴ See Statement of Commissioner Mark P. Wetjen before the Open Meeting of the Commodity Futures Trading Commission (Sept. 17, 2014), available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/wetjenstatement091714>.

⁵ See Opening Statement of Commissioner J. Christopher Giancarlo, Open Meeting on Proposed Rule on Margin Requirements for Uncleared Swaps and Final Rule on Utility Special Entities (Sept. 17, 2014), available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/giancarlostatement091714>.

point, and that one consideration was whether the National Futures Association would have a role in reviewing such models.

Finally, a number of commissioners raised questions about how the margin rules would be applied in the cross-border context. Unlike the PR Margin Proposal, the CFTC staff indicated, the CFTC proposal would contain a request for comments in the form of an “advance notice of proposed rulemaking” rather than proposed rules. In particular, CFTC staff indicated, the ANPR would present three potential options: (i) follow the CFTC cross-border guidance (*i.e.*, treat margin as an “transaction-level requirement”),⁶ (ii) follow the approach taken in the PR Margin Proposal⁷ or (iii) follow a hybrid approach akin to treating margin as an “entity-level requirement under the Cross-Border Guidance”.⁸

Under the approach in the Cross-Border Guidance, (i) U.S. swap dealers would be required to apply CFTC margin requirements with all of their counterparties;⁹ and (ii) non-U.S. swap dealers (a) would be required to apply CFTC margin requirements with U.S. person counterparties, (b) could use “substituted compliance” in transactions with foreign branches of U.S. bank swap dealers and non-U.S. persons that are guaranteed by, or conduit affiliates of, a U.S. person, and (c) would not be subject to CFTC margin requirements in transactions with non-U.S. persons that are not guaranteed by, or conduit affiliates of, a U.S. person.¹⁰ Under the PR Margin Proposal, swaps between two non-U.S. entities, neither of whom are guaranteed by a U.S. entity, would be excluded from the Prudential Regulators’ margin requirements. Non-U.S. swap dealers and major swap participants who do not have U.S. Guarantors would be able to comply with a foreign regulatory framework for uncleared swaps with any counterparty, U.S. or non-U.S., if the Prudential Regulators determined that such a framework was comparable to the U.S. margin requirements.¹¹

* * * * *

⁶ See *Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations*, 78 Fed. Reg. 45292 (July 26, 2013) (“**Cross-Border Guidance**”).

⁷ See summary of the PR Margin Proposal, *supra* note 3.

⁸ It is not clear what exactly this would entail, based on the discussion during the open meeting.

⁹ The Cross-Border Guidance also provides “substituted compliance” for foreign branches of U.S. banks in certain situations, but such entities would be subject to the Prudential Regulators’ margin requirements.

¹⁰ Cross-Border Guidance at 45369. Note that it is unclear how the Cross-Border Guidance would apply as currently written, given that, at the time the Cross-Border Guidance was published, the CFTC margin proposals would not have required Covered Swap Entities to post margin (*i.e.*, only to collect margin). It is also unclear at this time how a “substituted compliance” determination might work, given that the U.S. margin proposals generally impose on entities a requirement to post and collect, whereas the European Union proposal would require certain entities to collect margin.

¹¹ The PR Margin Proposal would also, in such a situation, excuse an entity subject to the Prudential Regulators’ margin requirements from the requirement to post margin in compliance with the Prudential Regulators’ rules (*i.e.*, they would need to post, as the non-U.S. entity is required to collect under the foreign regulatory framework).

Please feel free to contact any of the following Cadwalader attorneys if you have any questions about this memo.

Jeff Robins	+1 212 504 6554	jeffrey.robins@cwt.com
Steven Lofchie	+1 212 504 6700	steven.lofchie@cwt.com
Nihal Patel	+1 212 504 5645	nihal.patel@cwt.com