

Clients & Friends Memo

CFTC, Prudential Regulators Propose Margin Rules for Non-Cleared Swaps

April 13, 2011

On April 12, 2011, the Commodity Futures Trading Commission (“**CFTC**”) voted 4-1 to issue proposed rules establishing minimum initial and variation margin requirements for non-cleared swaps entered into by CFTC-regulated swap dealers and major swap participants.¹ Later the same day, 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 (collectively, “**Prudential Regulators**”) jointly issued their own rules establishing margin requirements for swap dealers and major swap participants that are subject to their respective prudential regulation.²

The Dodd-Frank Act (Sections 731 and 764) requires the CFTC, SEC,³ and Prudential Regulators to adopt rules imposing initial and variation margin for certain non-cleared swaps entered into by swap dealers (“**SDs**”) and major swap participants (“**MSPs**”). The CFTC and SEC have the responsibility to establish margin requirements for SDs and MSPs that are not primarily supervised by the Prudential Regulators.⁴ Similarly, the Prudential Regulators have the responsibility to establish margin requirements for SDs and MSPs that are subject to their supervision, including domestic banks and thrifts, foreign banks, bank and savings and loan holding companies, Farm Credit Administration-chartered banks, and the government-sponsored enterprises. Although margin requirements for non-cleared swaps are potentially significant and highly anticipated, the

¹ Commissioner Scott O'Malia dissented, citing, among other things, a “lack of harmonization” in the proposed margin requirements applicable to financial companies and commercial end-users.

² The text of the CFTC's proposal is not yet publicly available. This memorandum is principally based upon the CFTC's “Fact Sheet” and “Q & A” regarding its proposed rules, statements at the CFTC's meeting, and on the Prudential Regulators' notice of proposed rulemaking that will appear in the Federal Register. Margin and Capital Requirements for Certain Swap Dealers and Major Swap Participants: Notice of Proposed Rulemaking to Implement Sections 731 and 764 of the Dodd-Frank Act (Apr. 12, 2011), available at <http://www.fdic.gov/news/board/Apr11no4.pdf>.

³ The SEC has not published a proposed rule establishing margin requirements for non-cleared securities-based swaps.

⁴ The CFTC has jurisdiction to impose capital and margin requirements on non-prudentially regulated SDs and MSPs. The SEC has jurisdiction to impose capital and margin requirements on securities-based swap dealers and major securities-based swap participants. For simplicity, we refer to both CFTC and SEC regulated-entities as SDs and MSPs, respectively.

proposed rules come close to the end of the scheduled year long rulemaking process for implementing Title VII of the Dodd-Frank Act. The delay reflects the challenge that regulators face when trying to implement Congress's goals of reducing systemic risk and promoting market integrity without inadvertently limiting access to important risk management products or compromising the competitiveness of the U.S. derivatives markets. Indeed, the CFTC is still attempting to finalize a proposed rule that would establish capital requirements for SDs and MSPs, and a related rule that would further define which agreements, contracts, and transactions constitute "swaps" under the Dodd-Frank Act. The CFTC noted that it currently expects to publish the rules proposing capital requirements and the definition of swap later in the month.

In its Q & A, the CFTC stated that it "consulted" with the Prudential Regulators in preparing its margin requirements, and that the SEC "participated" in these consultations. It is not clear whether the CFTC's choice of words indicates some difference in the relative relationships between the different agencies. Nevertheless, it is probably more important that the CFTC and the Prudential Regulators harmonize their requirements because banks will act as dealers in interest rates and currencies, both of which will also be regulated by the CFTC, whereas banks likely will not act as dealers in securities-based swaps regulated by the SEC.

While there are significant commonalities in the approaches taken by the CFTC and the Prudential Regulators, as described below, there are also significant differences, particularly with regards to the use of models and the treatment of commercial end-users.

Timing of the Proposed Margin Rules

The comment period for the CFTC's proposed margin rule will run concurrently with the comment period for the proposed rule establishing capital requirements for SDs and MSPs that is expected to be published later this month (*i.e.*, comments to the CFTC's margin rule will be due on the same day as comments to the capital rule, 60 days after the rule establishing capital requirements for CFTC-regulated entities is published in the Federal Register).

The comment period for the Prudential Regulators' proposed capital and margin rules will close on June 24, 2011. As a preliminary indication of the large number and broad range of issues associated with the new margin requirements, the draft of the proposed rule distributed by the Prudential Regulators alone includes 92 numbered questions, many of which have several subcomponents.

Products Covered

The margin rules issued by the CFTC and Prudential Regulators will apply only to non-cleared swaps entered into *after* the effective date of the regulations (*i.e.*, margin requirements will not be applied retroactively).⁵ This should provide some degree of comfort to market participants, including structured products vehicles, that may have been unable to effectively renegotiate preexisting swaps to comply with the new margin requirements. In addition, the Prudential Regulators (but not the CFTC) would permit a registrant that uses a model to calculate its initial margin requirements on a portfolio basis to include only post-effective-date swaps in the relevant portfolio. With respect to variation margin, the Prudential Regulators have proposed requiring covered swap entities to comply with the margin requirements for *all* swaps governed by a master agreement, regardless of the date on which they were entered into, but have requested comment as to whether this requirement would raise practical difficulties for market participants. Similarly, the CFTC agreed to include a question to market participants in preamble to its proposed rule asking whether non-cleared swaps entered into before the effective date could be used to offset related positions.

Categories of Non-Cleared Swap Transactions

The CFTC and Prudential Regulators have proposed different margin requirements depending whether the counterparty to a swap is an SD or MSP, a financial entity (*i.e.*, a “financial end-user”),⁶ or a non-financial entity (*i.e.*, a “commercial end-user”).

SD/MSP to SD/MSP Swaps. In general, the requirements in the CFTC’s and Prudential Regulators’ rules are the same. Both parties would be required to pay and to collect initial and variation margin for each trade. Variation margin must be calculated and paid or collected at least once per business day.

SD/MSP to Financial Entity Swaps. In general, the requirements in the CFTC’s and Prudential Regulators’ rules are the same. SDs and MSPs would be required to collect (but not to pay) initial and variation margin for each trade.⁷ Variation margin

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⁵ Consistent with current industry practice, under the proposed rules cleared swaps will be subject to the rules of the applicable derivatives clearing corporation.

⁶ The proposed rules define a “financial entity” or “financial end-user” in a manner that is consistent with the definition of “financial entity” in CEA Section 2(h)(7) (the end-user clearing exception).

⁷ Presumably SDs and MSPs would not be prohibited from paying margin to a counterparty that is a financial entity pursuant to the terms of a bilaterally negotiated swap; however, the Fact Sheet provided by the CFTC ambiguously states that “for trades between SD/MSPs and financial entities, the rules would require the SD/MSP to collect, but not to pay, initial and variation margin for each trade . . .”).

must be calculated and paid or collected at least once per business day.⁸ Under certain circumstances, margin requirements may be subject to minimum thresholds. For example, a low-risk financial end-user with a relatively small swap portfolio that uses swaps primarily to hedge its commercial risk (e.g., an insured depository institution) may qualify for initial and variation margin thresholds that would reduce the amount of margin that such a counterparty is required to post.

SD/MSP to Non-Financial Entity Swaps. The CFTC's proposed rule would require SDs and MSPs to enter into credit support arrangements with their non-financial counterparties, but *would not require* the SD or MSP to pay or to collect initial or variation margin.⁹ Although the Prudential Regulators do not establish an explicit minimum threshold for initial or variation margin, their proposed rule *would require* SDs and MSPs to calculate a credit exposure limit for non-financial entities and collect (but not pay) initial and variation margin when the credit exposure exceeds the calculated limit.

Interestingly, at the CFTC open meeting, both Commissioners Sommers and O'Malia appeared to criticize the Prudential Regulators for not providing an exception from margin requirements for commercial end-users. For their part, the Prudential Regulators, in their release, raise the question as to whether the CFTC has statutory authority under Section 731 of the Dodd-Frank Act to except commercial end-users from posting margin, emphasizing the policy significance of protecting SDs against any swap credit risk created by commercial end-users.

Calculation of Margin

The CFTC's proposed rule would require initial margin to be calculated in a manner that covers 99% of all 10-day price moves using a model that is approved by the CFTC and: (1) used by a clearinghouse for clearing swaps; (2) used by an entity subject to oversight by one of the Prudential Regulators; or (3) made available for licensing to any market participant by a vendor. If no model is available, SDs and MSPs must identify a comparable cleared swap and then use a multiplier to reflect the greater risk associated with the non-cleared product.

The Prudential Regulators' would permit SDs and MSPs to calculate their initial margin required by either: (1) using a standardized "lookup" table that specifies the minimum initial margin that must

⁸ The CFTC and Prudential Regulators have not indicated whether a failure to pay or collect variation margin would result in a default (either immediately or after a specified period of time) or in a capital charge to the swap dealer or major swap participant.

⁹ Notwithstanding the proposed rule, a swap dealer or major swap participant and non-financial entity could negotiate margin requirements as part of a bilateral agreement.

be collected based on a percentage of a non-cleared swap's notional amount; or (2) using an internal model that is approved by the entity's primary regulator.¹⁰

Forms of Acceptable Margin

In general, the CFTC's proposed rule would only recognize cash, Treasuries, and senior debt obligations of certain government-sponsored entities ("GSEs"); however, for non-cleared swaps between an SD or MSP and a non-financial entity, the CFTC's proposal would permit any form of collateral agreed to by the parties (e.g., physical natural gas in storage), provided that any non-traditional collateral must be revalued on a periodic basis.

In general, the Prudential Regulators' proposed rule would only recognize cash, Treasuries, and senior debt obligations of GSEs. Non-cash collateral would be subject to a mandatory haircut for purposes of determining their margin value. The Prudential Regulators have requested comment on expanding the types of eligible collateral, potentially to include asset-backed securities and foreign sovereign debt.

Segregation of Margin

For non-cleared swaps between SDs and MSPs, the CFTC's proposed rule would require all collateral to be held by a third-party custodian. For all other non-cleared swaps, the SD or MSP would only be required to offer the counterparty the opportunity to have any margin held in such a segregated account.¹¹

The Prudential Regulators' proposed rule would require all collateral to be held by an independent third-party custodian for non-cleared swaps between SDs and MSPs.

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¹⁰ Interestingly, by contrast to the Prudential Regulators, the CFTC does not appear to have provided itself with the ability to approve models.

¹¹ The CFTC staff indicated that the custodian in this context could be an affiliate of the swap dealer or major swap participant.

If you have any questions about the foregoing, please feel free to contact any of the following attorneys:

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