

Clients & Friends Memo

Prudential Regulators Release Final Margin Rules for Swaps

October 23, 2015

On October 22, 2015, the Federal Deposit Insurance Corporation held an open meeting at which it voted to adopt: (i) final rules governing margin and capital requirements for uncleared swaps¹ and (ii) an interim final rule to implement statutory amendments excluding certain entities from the requirements.² The Rules, which were also approved by the Comptroller of the Currency and are to be jointly adopted by the other “Prudential Regulators,”³ set margin requirements for uncleared swaps and uncleared security-based swaps entered into by swap dealers, security-based swap dealers, major swap participants and major security-based swap participants who are supervised by a Prudential Regulator (such entities, “**Covered Swap Entities**”).⁴

Consistent with the international framework published by the Basel Committee on Banking Supervision and the International Organization of Securities Commissions⁵ (and the rules proposed in September 2014),⁶ the Margin Rule requires Covered Swap Entities to collect and post variation margin (“**VM**”) on Swaps with counterparties who are swap dealers, security-based swap dealers, major swap participants and major-security-based swap participants (“**Swap Entities**”) or “financial end users.” The Margin Rule also requires two-way deliveries of initial margin (“**IM**”) into segregated accounts where counterparties are Swap Entities or financial end users with “material swaps exposure.” The compliance schedule provided in the Margin Rule matches the

¹ See Final Rule to Establish Margin and Capital Requirements for Covered Swap Entities (unofficial text), available at https://fdic.gov/news/board/2015/2015-10-22_notice_dis_a_fr_final-rule.pdf (“**Margin Rule**”).

² See Interim Final Rule to Exempt Commercial End Users and Small Banks (unofficial text), available at https://fdic.gov/news/board/2015/2015-10-22_notice_dis_a_fr_interim-final-rule.pdf (“**Interim End User Exemption**”) and collectively with the Margin Rule, the “**Rules**”).

³ The “Prudential Regulators” consist of the FDIC, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Farm Credit Administration, and the Federal Housing Finance Agency.

⁴ For ease of reference, the term “**Swaps**” will be used in this memorandum to mean both swaps and security-based swaps unless the context requires differentiation.

A Cadwalader summary of the proposal by the Commodity Futures Trading Commission (“**CFTC**”) to implement margin requirements for swap dealers and major swap participants subject to their jurisdiction is available [here](#).

⁵ See “[Margin Requirements for Non-Centrally Cleared Derivatives](#)” (Mar. 2015) (“**BCBS-IOSCO Framework**”).

⁶ [79 Fed. Reg. 57348](#) (Sept. 24, 2014) (the “**Proposal**”). A Cadwalader summary of the Proposal is available [here](#).

recommendations of BCBS-IOSCO Framework, with an initial compliance date of September 1, 2016 for the largest market participants, “big-bang” implementation of VM requirements for all other market participants on March 1, 2017, and phased implementation of initial margin requirements on an annual basis thereafter.

Given the highly detailed nature of the Margin Rules, time will be required to fully analyze the various requirements. In the interim, the following is an initial summary of notable elements of the Margin Rule focusing primarily on changes from the Proposal.

Scope: Under the Margin Rule, a Covered Swap Entity will not be required to collect or post specified amounts of variation margin or initial margin on Swaps with counterparties that are not Swap Entities or “financial end users” as defined in the rule. The Margin Rule retains the “financial end user” concept used in the Proposal, which is intended to provide greater clarity than the “financial entity” concept used in the statutory exemption from mandatory clearing. Financial end users are generally: (i) entities engaging in financial activities (deposit taking, lending, securities and derivatives trading, insurance, asset management, and advisory service) that subject them to registration or chartering requirements under federal or state law, (ii) pooled investment vehicles, and (iii) equivalent non-U.S. entities. Swaps with entities that are not financial end users are exempt from mandatory margin requirements under the Margin Rule without regard to whether they hedge commercial risk. In addition, to implement the requirements of Title III of the Terrorism Risk Insurance Program Reauthorization Act of 2015, the Interim End User Exemption separately provides that the requirements of the Margin Rule will not apply where the counterparty would be eligible for an exemption from mandatory clearing under the Commodity Exchange Act or CFTC rules (or under comparable Securities Exchange Act and SEC requirements).⁷ The result appears to be a relatively broad but highly-complicated set of exemptive criteria for non-financial commercial entities, small banks and cooperatives.

Material Swaps Exposure and other Thresholds: The threshold for the imposition of IM requirements was set at an average aggregate notional amount of Swaps (including exempted FX swaps) of \$8 billion, which is in line with the BCBS-IOSCO Framework and greater than the \$3 billion that was previously proposed. To determine whether it is above or below this threshold in any given year, a financial end user would need aggregate the notional amounts for its own swap book with that of “affiliates” who are consolidated (or would be consolidated) for purposes of preparing financial statements under generally accepted accounting standards. This represents a change from the Proposal, which would have required aggregation based on a definition of “affiliate” derived from the securities-law concept of “control.” In addition, swaps that are eligible for an exemption from mandatory clearing can now be excluded from the count. More broadly, the Prudential Regulators adjusted various dollar-denominated thresholds in the Margin Rule to reflect

⁷ See [Terrorism Risk Insurance Program Reauthorization Act of 2015](#), Pub. L. No. 114-1.

an assumed 1-to-1 conversion rate to the euro. The result is that these thresholds have been lowered relative to the Proposal in order to keep them in line with the BCBS-IOSCO Framework.

Securitizations: The Prudential Regulators did not modify the financial end user definition to provide an exclusion for structured finance vehicles or covered bond issuers. Indeed, the preamble of the Margin Rule indicates that the Prudential Regulators believe such issuers should be classified as financial end users. As a consequence, Covered Swap Entities dealing with these issuers would be required to collect (and post) variation margin with respect to Swaps entered into after March 1, 2017.

Eligible Collateral for VM: For transactions with another Swap Entity, the eligible collateral list for VM has been expanded to include 10 “major currencies” as well as USD and the “currency of settlement” for the relevant Swap.⁸ For transactions with a financial end user, the list of eligible collateral has been further expanded to include all assets that are eligible as IM, including various liquid debt and equity securities. While this expansion is a victory for end users with difficulty posting cash, non-cash margin that is denominated in a currency different than the “currency of settlement,” is subject to an 8% cross-currency haircut. The Margin Rule does not provide useful guidance as to how to implement this haircut under circumstances where transactions under a single netting agreement settle in different currencies.

Eligible Collateral for IM: The Margin Rule is generally consistent with the Proposal as to the eligible collateral list for initial margin. In addition to currencies, various government debt securities, corporate debt securities and equities that are deemed by the Prudential Regulators to be high-quality liquid assets, certain money market mutual funds that invest in U.S. Treasury securities or similar non-U.S. sovereign debt securities were added to the list. Cross currency haircuts would not apply to collateral posted as IM provided that the currency of the collateral matches either the currency of settlement for the transactions or an agreed termination currency specified under the relevant master netting agreement for net payments that become due upon a default or other close-out event.

Limitations on Cash IM: Among other requirements, terms for segregating IM at a custodian must provide that the custodian is not permitted to rehypothecate or otherwise use segregated assets. Cash collateral that would be treated as a general deposit account at a bank custodian will be permissible only if the funds are used to purchase a permissible non-cash asset within a time period reasonably necessary to consummate such a purchase.

⁸ The “currency of settlement” is defined as the currency in which the parties have agreed to discharge normal course payments for the specific swap or security-based swap.

Netting: For portfolios of multiple Swaps, VM requirements can be calculated on a net basis and risk offsets can be recognized in calculating IM requirements, provided that the Swaps are under an “eligible master netting agreement.” For this purpose, the definition of eligible master netting agreement was amended to provide that impermissible “walk-away” clauses do not include clauses that merely suspend payment obligations when the counterparty defaults. Netting opinions will be required to establish a well-founded legal conclusion that close-out rights will not be stayed or avoided under applicable insolvency law, other than temporary stays applicable under the Federal Deposit Insurance Act, Title II of the Dodd-Frank Act or certain similar U.S. or foreign laws. No relief was provided for transactions with insurance companies, pension plans, or municipalities where it may not be possible to obtain a netting opinion.

Inter-Affiliate Transactions: While the Proposal would have required full two-way margining for transactions with affiliates, the Margin Rule will require Covered Swap Entities to collect but not post IM when transacting with affiliates. In addition, a Covered Swap Entity is permitted to offer a collateral threshold of up to \$20 million to each affiliate with which it trades (there is no aggregation requirement among affiliates connected to this permitted threshold). Finally, where an inter-affiliate swap would be required to be cleared but for an exemption, the IM requirement under a models-based approach to margin is reduced.

Legacy Transactions: One oft-noted concern with the Proposal was that grandfathering for legacy Swap transactions would have been lost where such transactions were included with regulated transactions under a single eligible master netting agreement. The final Margin Rule is intended to provide for the ability to margin separate “netting portfolios” under a single eligible master netting agreement.

No Hotel California: While the Margin Rule technically provides that parties remain subject to margin requirements at all times after the initial compliance date, it also provides new rules specifying the consequences of a change in status. Where a change would make the rules stricter, the stricter rules will apply for new Swaps entered into after the change. Where a change would make the rules less strict (e.g., a financial end user’s portfolio shrinks below the “material swaps exposure” threshold for IM requirements), the Covered Swap Entity may comply with the less strict requirements for all outstanding Swaps (e.g., IM requirements would no longer apply).

Cross-Border Application: The cross-border requirements are substantially similar to the Proposal. For transactions by a foreign branch of a U.S. Covered Swap Entity that is a bank or a non-U.S. Covered Swap Entity that is a subsidiary of a bank with a counterparty in a jurisdiction that imposes impediments to segregation of IM, special new rules would excuse posting of IM in some cases, subject to written approval from the relevant Prudential Regulator.

* * * *

Please feel free to contact any of the following Cadwalader lawyers if you have any questions about this Clients & Friends Memo.

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