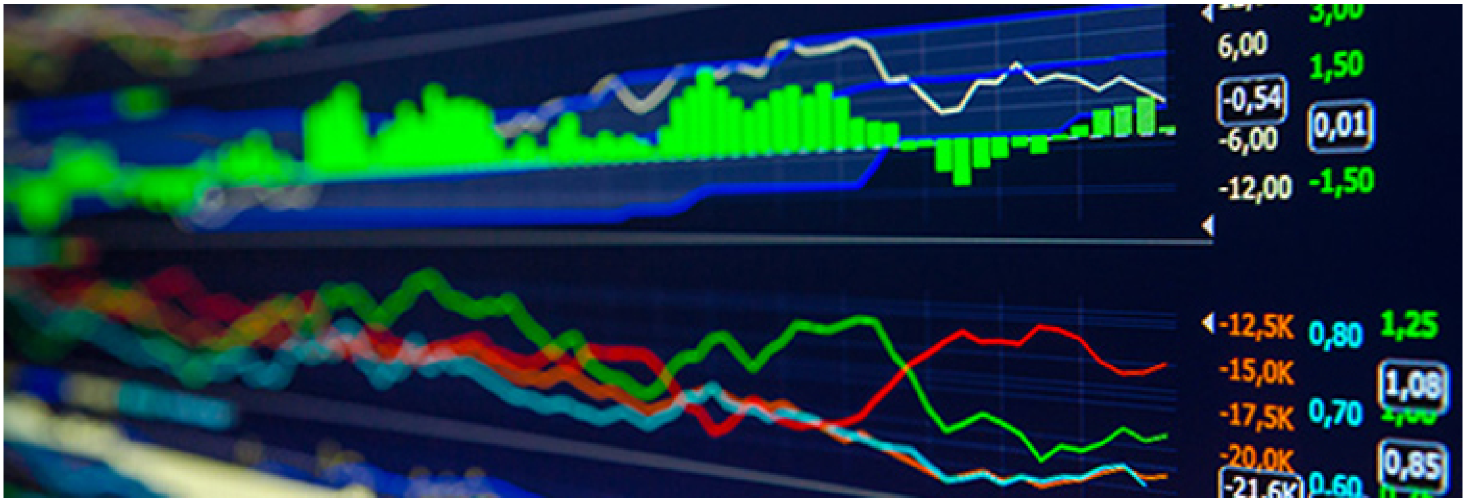

Life on the margin: US margin rules finalized at last

Derivatives Alert

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More than five years after the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the US Commodity Futures Trading Commission has adopted a final rule regarding margin for uncleared swaps (the CFTC margin rule) and an interim final rule exempting non-financial and certain other end-users who are eligible for the end-user clearing exception from the scope of the CFTC margin rule. Accordingly, non-financial end-users who rely on the end-user exception are exempt from margining requirements.

The CFTC's final rule, adopted in December 2015, supplements the final margin rule adopted in October 2015 by a group of US “prudential regulators," namely the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Farm Credit Administration, and the Federal Housing Finance Agency (the bank margin rule). The CFTC deferred to the “prudential regulators” so that any swap entered into by a swap dealer (SD) or major swap participant (MSP) that is regulated by a prudential regulator is subject to the bank margin rule and not the CFTC margin rule.

While the two rules are not identical, the CFTC indicated in its discussion that the CFTC margin rule “essentially provide[s] for the same treatment as the [bank margin rule] with a few exceptions.”[1] The CFTC margin rule and the bank margin rule are collectively referred to herein as the “margin rules.”

WHICH TRADES ARE COVERED?

The margin rules apply only to uncleared swaps entered into after the applicable compliance date. Based on the Secretary of Treasury determination in 2012 to exempt foreign exchange swaps and deliverable foreign exchange forwards from the definition of "swap" for purposes of application of margin rules and for certain other purposes, transactions in these products are not required to be margined under the margin rules.[2] Cross currency swaps[3] are covered, but initial margin calculated using a model need not recognize any risks or risk factors associated with the fixed, physically-settled foreign exchange transactions associated with the exchange of principal embedded in the uncleared cross-currency swap.[4] Non-deliverable foreign exchange forwards and currency options are considered swaps and are covered by the margin rules.

The margin rules require bilateral margining by both SDs and MSPs and their counterparties who are subject to the margin rules.

WHAT TYPES OF ENTITIES ARE COVERED?

The margin rules apply to covered swaps if (i) both parties are SDs or MSPs or (ii) one party is an SD or MSP and the other party is a "financial end-user." Financial end-users are non-SDs and non-MSPs and include, but are not limited to:

- Banks and other depository institutions
- Bank holding companies
- State-licensed credit or lending entities, including finance companies, money services businesses and currency dealers
- Securities holding companies, brokers, dealers, investment companies and investment advisers
- Private funds[5]
- Commodity pools, commodity pool operators and commodity trading advisors;
- Employee benefit plans, including ERISA plans
- Insurance companies
- Entities or arrangements that raise or accept money for clients or investors or uses its own funds for investing or trading in loans, securities, swaps funds or other assets.

Securitization vehicles that fit within any of the enumerated categories are covered.

The following entity types are excluded from the definition of "financial end-user":

- Sovereign entities
- Multilateral development banks
- The Bank for International Settlements
- Captive finance companies whose swaps are exempt from clearing
- Treasury affiliates whose swaps are exempt from clearing or otherwise exempt from the CFTC margin rule by rule.

WHAT ABOUT INTER-AFFILIATE SWAPS?

Inter-affiliate swaps are treated differently under the two margin rules.

CFTC margin rule

Under the CFTC margin rule, initial margin generally is not required to be posted if the conditions set forth for a clearing exemption in the CFTC's 2013 final rule entitled "Clearing Exemption for Swaps Between Certain Affiliated Entities" are satisfied. [6] However, SDs and MSPs that are subject to the CFTC margin rule must collect initial margin from non-US affiliates that are not subject to comparable initial margin requirements on these affiliates' swaps with third party financial end-users. In addition, SDs and MSPs trading with affiliates that are subject to the bank margin rule must post initial margin as required by that rule. Variation margin must be posted to and collected from each affiliate that is a SD, MSP or financial end-user.

Bank margin rule

Under the bank margin rule, a covered SD or MSP must collect initial margin from its affiliate counterparties that are SDs, MSPs or financial end-users, and must post initial margin only to SD and MSP affiliates, in each case subject to a $20 million threshold. If the covered SD or MSP is not required to post initial margin, it still must calculate daily the amount of initial margin that would have been required if its counterparty was not an affiliate. Variation margin must be posted and collected to and from each affiliate that is a SD, MSP or financial end-user.

WHAT ARE THE INITIAL MARGIN REQUIREMENTS?

SDs and MSPs must collect initial margin from, and post initial margin to, financial end-users that have “material swaps exposure” and to other SDs and MSPs regardless of exposure. An entity has material swaps exposure if the average daily notional amount of its uncleared swaps, including security-based swaps, deliverable foreign exchange forwards and foreign exchange swaps, exceeds $8 billion during June, July and August of the previous year. Initial margin may be calculated using an approved risk-based model or based on a standardized table that sets minimum gross margin requirements based on product type and trade duration. SDs and MSPs may apply an initial margin threshold of up to $50 million on a consolidated entity level including all affiliates of both parties, subject to a minimum transfer amount (MTA) not to exceed $500,000 in aggregate with the MTA applied to variation margin. Initial margin must be held for the duration of the transaction with a qualifying custodian under the applicable custodian rules and may not be offset against variation margin collected from the counterparty.

WHAT ARE THE VARIATION MARGIN REQUIREMENTS?

On a daily basis, SDs and MSPs must collect variation margin from, and post variation margin to, financial end users and to other SDs and MSPs, in each case regardless of exposure. No threshold is permitted, although an MTA not to exceed $500,000 may be employed to the extent not used in the determination of initial margin.

WHAT TYPES OF COLLATERAL CAN BE POSTED?

The margin rules specify permissible collateral types for initial and variation margin. Variation margin must be posted in cash in any major currency or a currency of settlement of the swap. The permissible collateral types for initial margin are broader and include US Treasuries and other enumerated securities. The margin value of securities posted as collateral must be reduced by haircuts of at least the amounts set forth in the margin rules.

WHAT DOCUMENTATION IS NEEDED?

Each SD and MSP must execute documentation with each counterparty that complies both with the CFTC’s swap trading relationship documentation rules and the margin rules. The CFTC’s swap trading relationship documentation rules require credit support arrangements including initial and variation margin requirements, if any, eligible collateral types with haircuts, investment and rehypothecation terms, and custodial arrangements.[7]

When an SD or MSP enters into uncleared swaps with another SD or MSP or a financial end-user, margin documentation must contain initial and variation margin terms that comply with the requirements of the margin rules. Margin documentation must contain specified valuation, initial margin calculation, and dispute resolution procedures.8]> Title transfers such as those effected under the ISDA Credit Support Annex (CSA) subject to English law published in 1995 would not be effective margin transfers under the margin rules.9 As expected by the industry, it is likely that parties will be required to use new collateral documentation tailored specifically for the margin rules.

HOW IS NETTING APPLIED?

In order to net exposures for both initial and variation margin, parties subject to the margin rules must have an “eligible master netting agreement.” The CFTC indicated in its discussion of the CFTC margin rule that it intended the criteria for an “eligible master netting agreement” to be “consistent with industry standards currently being used”[10] for determining eligibility for netting for bank regulatory capital purposes. This requirement would foreclose netting when SDs and MSPs trade with financial end-users organized in jurisdictions in which industry standard legal opinions are not available and with counterparty types where the SD or MSP cannot (or does not) obtain required netting and enforceability opinions.

The margin rules contemplate that swap participants may create separate margining portfolios under a single eligible master netting agreement, with margining occurring on a net basis within each separate margining portfolio. For example, parties could use their existing pre-compliance collateral documentation, if any, to margin (or not margin) all swaps executed prior to the relevant compliance date, and use post-compliance collateral documentation to margin only a portfolio of post-compliance trades. However, the margin rules require that each swap under a separate margining portfolio be margined in accordance with the margin rule requirements if at least one swap in the portfolio is a covered by the rule. That is, if separate margining portfolios are not created, then the margin rules will apply to both pre-compliance and post-compliance swaps.

It does not appear mandatory that the netting and enforceability opinions required for an "eligible master netting agreement" set forth the differences under applicable insolvency law, if any, between the treatment of separate margining portfolios under a single eligible master netting agreement and such an agreement with a single margining portfolio.

WHAT ARE THE CUSTODIAN REQUIREMENTS?

The margin rules do not require any variation margin to be held with a custodian. However, all initial margin posted and collected under the margin rules must be held with an unaffiliated custodian pursuant to an enforceable custody agreement and may not be rehypothecated. Accordingly, SDs and MSPs will need to obtain enforceability opinions on its custody agreements in the jurisdictions of both the custodian and its counterparty.[11]

WHEN ARE THE COMPLIANCE DATES?

The margin rules contain phased compliance dates based on the magnitude of the parties' swap positions. The compliance dates are as follows:

- September 1, 2016, if the average daily aggregate notional amount of both parties' and their qualifying affiliates' uncleared swaps, including security-based swaps, deliverable foreign exchange forwards and foreign exchange swaps (collectively, the ADANA), exceeds $3 trillion during March, April and May of 2016
- March 1, 2017, for variation margin between SDs and MSPs and any other counterparty
- September 1, 2017, for initial margin, if the ADANA exceeds $2.25 trillion during March, April and May of 2017
- September 1, 2018, for initial margin, if the ADANA exceeds $1.5 trillion during March, April and May of 2018
- September 1, 2019, for initial margin, if the ADANA exceeds $0.75 trillion during March, April and May of 2019 and
- September 1, 2020, for all other initial margin.

Find out more about the margin rules and their implications for your business by contacting any of the authors.

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[1] 81 Fed. Reg. 638 (January 6, 2016).

[2] Foreign exchange swaps and deliverable foreign exchange forwards are counted in the calculation of "material swaps exposure" for purposes of calculating initial margin requirements.

[3] In a cross-currency swap, one party exchanges with another party principal and interest rate payments in one currency for principal and interest rate payments in another currency, and the exchange of principal occurs upon the inception of the swap, with a reversal of the exchange of principal at a later date that is agreed upon at the inception of the swap.

[4] 17 CFR §23.154(b)(2)(iv).

[5] The term "private fund" refers to the definition of that term in Section 202(a) of the Investment Advisers Act of 1940, as amended, and means an issuer that would be an investment company, as defined in section 3 of the Investment Company Act of 1940, but for the exclusions provided in Section 3(c)(1) or 3(c)(7) of that Act (e.g., hedge funds, private equity funds, and other privately offered investment funds).

[6] 17 C.F.R. **§** *50.52.*

[7] 17 CFR §23.504(b)(3).

[8] 17 CFR 23.158(b).

[9] 81 Fed. Reg. 672 (January 6, 2016).

[10] 81 Fed. Reg. 686 (January 6, 2016).

[11] *See* 81 Fed. Reg. 670 (January 6, 2016).

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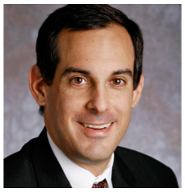

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