Margin Requirements for Swaps and Security-based Swaps

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Prior to the 2008 financial crisis, parties to over-the-counter derivatives negotiated the level of collateralization or margin that would apply to their trades. Due to the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") in 2010 and the promulgation of rules under that law by the relevant regulators during the intervening years, margin levels will be imposed by regulation and the use of individually negotiated margin levels will decline. This article describes the new margin regime that will apply to the sell-side derivatives dealers and, through them, to their buy-side counterparties.

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Investment advisers should begin to analyze the trading portfolios of their clients in order to determine how the [Prudential Regulators'] Rules and other margin rules may affect their trading strategies in the future.

The Dodd-Frank Act contemplates a universe of cleared derivatives transactions, where both initial (upfront) margin and variation (mark-to-market) margin are prescribed and collected by the relevant clearing house through its clearing members. To date, most interest rate and credit derivative index trades are subject to a mandatory clearing requirement whereby such trades are margined pursuant to clearing house rules. Yet there are a number of types of derivatives transactions that are not subject to mandatory clearing and are not cleared. Because uncleared derivatives were determined by Congress to present a greater risk to market participants than cleared derivatives, the Dodd-Frank Act requires that margin requirements be imposed on uncleared derivatives transactions to help ensure the safety and soundness of market participants and the financial system.

The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency (collectively, the "Prudential Regulators") were tasked by the Dodd-Frank Act with determining margin requirements for uncleared swaps and uncleared security-based swaps in consultation with the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC"). On October 30, 2015, the Prudential Regulators adopted final margin rules for swaps and security-based swaps which become effective April 1, 2016, having previously adopted interim final rules relating to the margin requirements at the end of October 2015 which also become effective April 1, 2016 (collectively, the "PR Rules"). The PR Rules apply to swap dealers and major swap participants that are regulated by the Prudential Regulators. Subsequently, on December 18, 2015, the CFTC adopted final margin rules for swaps that apply to those participants that are registered with the CFTC as swap dealers or major swap participants but are not regulated by the Prudential Regulators. The CFTC final margin rules are largely similar to the PR Rules and also become effective on April 1, 2016. As of March 1, 2016, the SEC had yet to adopt final margin rules for security-based swaps. Importantly, rulemaking by both the Prudential Regulators and the CFTC clarifies that the margin rules will not apply to uncleared swaps if the counterparty to the swap qualifies for the commercial end-user exception to clearing, qualifies for an exemption from clearing pursuant to CFTC rule or order concerning cooperative entities or, if an affiliate, satisfies the clearing exception for affiliates.

Most buy-side participants customarily transact derivatives with the large dealers, which are regulated by the Prudential Regulators, although buy-side par-

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ticipants may transact with some non-bank subsidiaries of these dealers that are registered as swap dealers with the CFTC and regulated by the CFTC but not the Prudential Regulators. Consequently, this article will focus on the PR Rules, although the CFTC final margin rules for swaps are largely similar.

The PR Rules apply to "Covered Swap Entities." These are entities that are swap dealers, major swap participants, security-based swap dealers or major security-based swap participants (collectively, "Swap Entities") that are regulated by a Prudential Regulator. The PR Rules regulate both the collection and posting of both initial margin and variation margin when Covered Swap Entities transact with counterparties, and the nature of the counterparty determines the obligations that the relevant Covered Swap Entity will have under the PR Rules. Possible categories of counterparties include: Covered Swap Entities, Swap Entities, Financial End Users ("FEU") having material swaps exposure ("FEU+"), FEUs not having material swaps exposure and other counterparties.

An FEU is an entity that is not a Swap Entity but whose business activity is primarily financial in nature. FEU's include, among others:

- investment advisers, investment companies, 3(c)(1) and 3(c)(7) private funds (including hedge funds), certain exempt investment companies, and business development companies;
- commodity pools, commodity pool operators, commodity trading advisors, floor brokers, floor traders, introducing brokers and futures commission merchants;
- brokers and dealers;
- banks, bank holding companies and their affiliates and other lenders;
- insurance and reinsurance companies; and
- employee benefit plans (including governmental plans).

FEUs do not include:

- Sovereign entities, multilateral development banks, finance subsidiaries and affiliates that are exempt from the clearing requirements for swaps.

An FEU has a material swaps exposure if it and its affiliates have an average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange forwards and foreign exchange swaps with all counterparties during June, July and August of the prior year that exceed $8 billion, excluding swaps and security-based swaps that are exempt from the mandatory clearing requirement.

Covered Swap Entities must collect initial margin from other Swap Entities and FEU+s. Covered Swap Entities must post initial margin to FEU+s and will also be required by their Swap Entity counterparties to post initial margin to those counterparties. Covered Swap Entities must collect initial margin from other counterparties at such times and in such forms and amounts that the Covered Swap Entity determines appropriately addresses the credit risk posed by the counterparty and the uncleared transaction. Covered Swap Entities are not required to collect or post initial margin for uncleared transactions that are exempt from the mandatory clearing requirement. Initial margin collected by a Covered Swap Entity cannot be less than zero and is set by the PR Rules. However, if a Covered Swap Entity uses an initial margin model that is approved by the Prudential Regulator, then such model may be used in lieu of the levels prescribed by the PR Rules. When posting initial margin, a Covered Swap Entity must post an amount as large as the amount that the Covered Swap Entity would be required to collect if it were the counterparty. Collection and posting of initial margin must occur on the business day following the trade date of the transaction and the initial margin must be maintained until the termination of the transaction. Nevertheless, initial margin is not necessarily required in all circumstances because the PR Rules permit a Covered Swap Entity to effect transactions without the benefit of initial margin up to a certain uncollateralized amount. A Covered Swap Entity may adopt an initial margin threshold amount of up to $50 million, below which it need not collect or post initial margin from or to a Swap Entity or FEU+. If an initial margin threshold amount is adopted by a Covered Swap Entity, then the exposures of the Covered Swap Entity and its affiliates, on the one hand, and the counterparty and its affiliates, on the other hand, would be analyzed in order to determine whether the threshold has been exceeded. Initial margin amounts will have to be adjusted as the underlying swap and security-based swap portfolio changes.

Covered Swap Entities must collect variation margin from and post variation margin to Swap Entities and FEUs on each business day from the business day following the trade date of a transaction until the transaction is terminated. Covered Swap Entities must collect variation margin from other counterparties at such times and in such forms or amounts that the Covered Swap Entity determines appropriately address the risk posed by the counterparty and the risks of the uncleared transaction. Collection and posting of variation margin is not required for uncleared transactions that are exempt from the mandatory clearing requirement.

Consistent with current market practice, the transfer of initial and variation margin amounts can be subject to a minimum transfer amount not to exceed $500,000.

The PR Rules specify the type of collateral that is acceptable for initial and variation margin. For transactions between a Covered Swap Entity and a Swap Entity or FUE+, variation margin collected or posted must be in cash in U.S. dollars, a major currency or the currency of settlement for the transaction. For such transactions, initial margin collected or posted must be in cash or other permissible collateral, which

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includes major currencies, U.S. treasuries and agencies, European Central Bank securities, securities of certain less risky sovereigns, gold, publicly traded common equity in the S&P 1500 index or similar index and redeemable securities in certain pooled funds (collectively, “Eligible Collateral”). Securities of affiliates, banking entities or their affiliates, market intermediaries, and nonbank financial institutions supervised by the Federal Reserve Board of Governors do not constitute Eligible Collateral. Furthermore, the value of Eligible Collateral is subject to discounting between 0.5% and 25%, depending upon the type and maturity of the Eligible Collateral.

Initial and variation margin determinations can be made on a net basis considering all transactions if the transactions in question are subject to an eligible master netting agreement. An eligible master netting agreement must be written and enforceable, permit termination of the agreement upon default of the other party and not contain a walkaway clause. Importantly, before netting can be utilized, the party must conduct a legal review of the master netting agreement and have a well-founded basis for the netting position taken and must establish and maintain written procedures to monitor possible changes in relevant law applicable to netting. Fortunately, the activities of the International Swaps and Derivatives Association, Inc. in obtaining and updating netting opinions will be extremely helpful in this regard.

Initial margin collected or posted by the Covered Swap Entity must be segregated and held at a custodian that is not affiliated with the Covered Swap Entity or its counterparty. The custodian must act pursuant to a legally enforceable written agreement that prohibits rehypothecation of collateral, although the agreement can permit the posting party to substitute collateral or direct the investment of collateral.

Fortunately for Covered Swap Entities that are not organized under the laws of the United States and are not a branch or subsidiary of any such entity, the PR Rules will not apply to transactions between such entities and a person that is not organized under U.S. law, a U.S. resident, a branch of an entity organized under the laws of the U.S. or a Swap Entity subsidiary of a U.S. entity. For other types of cross-border transactions, substituted compliance with foreign law may also be possible.

The PR Rules are designed to be phased in from September 1, 2016 to September 1, 2020, with the phase-in schedule based upon the average daily outstanding notional amount of uncleared transactions between the parties to the transaction and their respective affiliates. Investment advisers should begin to analyze the trading portfolios of their clients in order to determine how the PR Rules and other margin rules may affect their trading strategies in the future.

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