

# Client Alert

November 14, 2014

## Prudential Regulators and CFTC Re-Propose Margin Requirement Rules for Uncleared Swaps

By Julian E. Hammar

The Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration, and the Federal Housing Finance Agency (collectively, the “Prudential Regulators”) published proposed rules for public comment in the Federal Register on September 24, 2014, regarding margin requirements for uncleared swaps and security-based swaps applicable to entities subject to their jurisdiction (e.g., registered swap dealers and major swap participants that are U.S. or foreign banks). The proposal is available [here](#). The Commodity Futures Trading Commission (“CFTC”) followed suit, publishing its proposed margin rules for uncleared swaps entered into by entities subject to its jurisdiction (e.g., registered swap dealers and major swap participants that are not U.S. or foreign banks) on October 3, 2014. The CFTC’s proposal is available [here](#). The comment periods for the two rulemaking proposals close on **November 24, 2014** and **December 2, 2014**, respectively.

### OVERVIEW OF PROPOSED MARGIN RULES

Both proposals are re-proposals of margin rules that the Prudential Regulators and the CFTC previously proposed in 2011. The re-proposals were made in response to comments received and the publication of the Final Policy Framework for Margin Requirements for Non-centrally Cleared Derivatives, published in September 2013 by the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions (“BCBS / IOSCO Final Policy Framework”), available [here](#). In general, the re-proposals would:

- Not impose margin requirements for uncleared swaps with non-financial end users;
- Require payment and collection of initial margin from financial end users with “material swaps exposure” and variation margin from all financial end users;
- Establish a compliance deadline of December 1, 2015 for variation margin and a phased compliance schedule for initial margin, extending from December 1, 2015 to December 1, 2019, depending upon uncleared swaps exposure;
- Detail eligible collateral to meet margin requirements: a list of items for initial margin with applicable haircuts and cash for variation margin;
- Include a threshold for initial margin under which it would not have to be collected;
- Require segregation of initial margin at a third-party custodian not affiliated with the transaction counterparties and prohibit re-hypothecation of initial margin;
- Not provide for an exemption from the margin requirement for uncleared swaps between affiliates; and
- Not apply to transactions entered into before the effective date, except that transactions subject to a master netting agreement applicable to pre-effective date transactions would be subject to the margin requirements.

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While the re-proposals of the Prudential Regulators and the CFTC are substantially similar, there are a few differences between them. In addition, the Prudential Regulators' and CFTC's proposals diverge from the BCBS / IOSCO Final Policy Framework in a few significant ways. The table below provides a detailed comparison of the two U.S. regulatory proposals, along with the BCBS / IOSCO Final Policy Framework.

Not included in the table are two topics that were not concretely addressed in the CFTC's proposal, but which should be mentioned. These topics are extraterritorial application of the uncleared margin rules and capital requirements, which we briefly summarize:

## EXTRATERRITORIAL APPLICATION OF PROPOSALS

With regard to extraterritorial application of the proposed rules, in general under the Prudential Regulators' proposal, the Prudential Regulators would not assert authority over trades between a non-U.S. swap dealer or major swap participant that is not guaranteed by a U.S. person and either a (i) non-U.S. swap dealer/major swap participant that is not guaranteed by a U.S. person or (ii) a non-U.S. person that is not guaranteed by a U.S. person. Unlike the Prudential Regulators' re-proposal, the CFTC's re-proposal does not include a proposed rule for how margin requirements for uncleared swaps would apply outside the U.S. Instead, the CFTC's re-proposal includes an advance notice of proposed rulemaking that offers three alternative approaches for public comment, including:

- Application of the rules in accordance with the Prudential Regulators' re-proposal;
- Application of the rules in accordance with the CFTC's Cross-Border Guidance applicable to Transaction-Level requirements; and
- Application of the rules in a form similar to the "Entity-Level requirements" in the CFTC's Cross-Border Guidance.

## CAPITAL REQUIREMENTS

Concerning capital, while the Prudential Regulators' proposal includes a regulation regarding capital requirements (basically requiring compliance with any existing regulatory capital regime for entities subject to their jurisdiction), the CFTC's proposal does not address capital requirements. The CFTC has indicated that it will publish a re-proposal for capital requirements separately.

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The following table is intended to assist our clients to navigate through these proposals, and to assess their impact on their operations. It is summary in nature, and should not be viewed as definitive legal advice.

## Comparison of CFTC Re-Proposal, Prudential Regulator Re-Proposal and BCBS / IOSCO Final Policy Framework

	CFTC Re-Proposal	Prudential Regulator Re-Proposal	BCBS / IOSCO Final Policy Framework	Comment
<b>Covered Entities</b>	All swap dealers (“SDs”) and major swap participants (“MSPs”) not regulated by a Prudential Regulator (“CFTC Covered Entities”).	All SDs, MSPs security-based swap dealers (“SBSDs”), and major security-based swap participants (“MSBSPs”) that are regulated by a Prudential Regulator <sup>1</sup> (“PR”) (“PR Covered Entities”).	All financial firms and non-financial firms that are systemically important as defined by national regulators.	Difference between CFTC and PRs reflects jurisdictional coverage (CFTC margin authority limited to SDs and MSPs, while PRs regulate SDs, MSPs, SBSDs, MSBSPs).
<b>Initial Margin Requirements</b>	CFTC Covered Entities must post and collect initial margin for swaps with an SD, MSP, and financial end user with material swaps exposure.	PR Covered Entities must post and collect initial margin for swaps and security-based swaps (“SBS”) with an SD, MSP, SBSD, or MSBSP or with a financial end user with material swaps exposure. <sup>2</sup>	Financial firms and systemically important non-financial firms must exchange initial margin.	Same between CFTC and PRs.  Material swaps exposure is \$3 billion average daily aggregate notional amount of uncleared swaps (and SBS under PRs’ proposal) with all counterparties for June, July, and August of the previous calendar year for financial end users (and their affiliates) under both CFTC and PRs’ proposals, while under BCBS/IOSCO initial margin not required to be posted/collected by entities with average daily aggregate notional amount of uncleared swaps below €3 billion (approx. \$11 billion under current exchange rates).

<sup>1</sup> Prudential Regulators are the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration, and the Federal Housing Finance Agency with respect to SDs, MSPs, SBSDs, and MSBSPs that are also entities regulated by these agencies, respectively.

<sup>2</sup> PRs define “material swaps exposure” to include SBS and swaps.

	<b>CFTC Re-Proposal</b>	<b>Prudential Regulator Re-Proposal</b>	<b>BCBS / IOSCO Final Policy Framework</b>	<b>Comment</b>
<b>Initial Margin Threshold (below which initial margin need not be posted)</b>	\$65 million between two consolidated groups.	\$65 million between two consolidated groups.	€50 million between two consolidated groups.	Consistent across approaches, accounting for currency difference.
<b>Segregation/Re-hypothecation of Initial Margin</b>	Initial margin must be segregated at a 3d party custodian or custodians not affiliated with the CFTC Covered Entity or counterparty.  Re-hypothecation by custodian of initial margin not permitted.	Same as CFTC.	Initial margin collector should give customer the option to individually segregate initial margin.  Customer may consent to re-hypothecation.	CFTC and PR Proposals are more restrictive than BCBS/IOSCO policy framework, since segregation is required and re-hypothecation is prohibited.
<b>Variation Margin Requirements</b>	CFTC Covered Entities must pay and collect variation margin for swaps with an SD, MSP and all financial end users.	PR Covered Entities must pay and collect variation margin for transactions with SDs, MSPs, SBSBs, MSBSPs and all financial end users.	Financial firms and systemically important non-financial firms must exchange initial and variation margin.	Same between CFTC and PRs.  Note that requirement to pay/collect variation margin applies to all financial end users, not just those with material swaps exposure (as in the case of initial margin).
<b>Variation Margin Threshold</b>	None.	None.	None.	Consistent across approaches.
<b>Segregation/Re-hypothecation of Variation Margin</b>	Segregation <u>not</u> required.  Re-hypothecation permitted.	Same as CFTC.	Same as CFTC and PR proposals.	Consistent across approaches.

	<b>CFTC Re-Proposal</b>	<b>Prudential Regulator Re-Proposal</b>	<b>BCBS / IOSCO Final Policy Framework</b>	<b>Comment</b>
<b>Definition of financial end user</b>	<p>Generally, the term “financial end user” is primarily based on an enumerated list of well-established financial market status types under various U.S. statutes/regulations (though non-U.S. entities must determine if they would qualify if they operated in the U.S.).</p> <p>The definition excludes sovereign entities, multilateral development banks (“MDBs”), the Bank for International Settlements, and certain entities (e.g., finance affiliates) that are specially exempted or excluded from mandatory clearing pursuant to CEA Section 2(h)(7)(C)(iii) or (D).</p> <p>MDBs are themselves an enumerated list of entities, and any other entity that provides financing for national or regional development in which the U.S. government is a shareholder or contributing member or which the CFTC/PRs determines poses comparable credit risk.</p>	Basically the same as CFTC with minor wording differences.	<p>Generally scope of “covered entities” includes financial firms and systemically important non-financial entities.</p> <p>Sovereigns, central banks, certain multilateral development banks, BIS and non-systemic, non-financial firms are excluded.</p>	<p>CFTC and PRs’ proposal does not define financial end user with reference to the definition of “financial entity” in Section 2(h) of the Commodity Exchange Act (“CEA”) or section 4(k) of the Bank Holding Company Act of 1956 (e.g., entities that engage in activities that are “financial in nature”) as was the case under the 2011 proposals.</p>

	<b>CFTC Re-Proposal</b>	<b>Prudential Regulator Re-Proposal</b>	<b>BCBS / IOSCO Final Policy Framework</b>	<b>Comment</b>
<b>Margin requirements for transactions with “other counterparties” (i.e., commercial end users)</b>	None.	PR Covered Entities must collect initial and variation margin (if any) for transactions with other counterparties as the PR Covered Entity determines appropriate to address the credit risk posed by the counterparty and the risks of such swaps or SBSs.	Financial firms and systemically important non-financial firms must exchange initial and variation margin.	Commercial end users not required to post margin under either CFTC or PRs’ approaches, although PR expressly states that PR Covered Entities must collect margin as appropriate.  BCBS/IOSCO does apply to systemically important non-financial firms, which could include commercial end users.
<b>“One-way” margin (applies to one party) or “two-way” margin (applies to both parties)</b>	Two-way	Two-way	Two-way	Consistent across all approaches.
<b>Minimum Transfer Amount</b>	\$650,000	\$650,000	€500,000	Consistent across all approaches accounting for currency difference.  Affects timing of collection only and does not change the amount of margin (whether initial or variation) that must be collected once the \$650,000 level has been exceeded.

	<b>CFTC Re-Proposal</b>	<b>Prudential Regulator Re-Proposal</b>	<b>BCBS / IOSCO Final Policy Framework</b>	<b>Comment</b>
<b>Products Covered</b>	<p>Uncleared swaps<sup>3</sup> excluding the fixed physically-settled FX component of cross-currency swaps.</p> <p>FX swaps and FX forwards are not subject to margin requirements because of the Treasury Secretary's determination.</p>	<p>Uncleared swaps (excluding the fixed physically-settled FX component of cross-currency swaps) and uncleared SBS.</p> <p>FX swaps and FX forwards are not subject to margin requirements because of the Treasury Secretary's determination. PR Covered Entities may be required to pay and collect variation margin for these instruments under PR supervisory guidance.</p>	<p>All uncleared OTC derivatives, but only variation margin for physically-settled FX forwards and FX swaps.</p>	<p>Potential competitive inequalities could result for PR Covered Entities if required to pay variation margin for FX swaps and FX forwards while CFTC Covered Entities would not be.</p>
<b>Interaffiliate Swaps</b>	<p>No exemption.</p>	<p>No exemption.</p>	<p>Decision left to national supervisors.</p>	<p>If national supervisors outside the U.S. provide an exemption, could place U.S. entities at a competitive disadvantage.</p> <p>Could potentially undermine the CFTC's inter-affiliate exemption from clearing in 17 CFR 50.52, inasmuch as the exemption does not require that interaffiliate swaps meeting the exemption's conditions be margined.</p>

<sup>3</sup> CFTC proposed to include within the definition of "cleared swap" excluded from the proposed margin rules certain swaps that have been accepted for clearing by an entity that has received a no-action letter or exemptive relief from the CFTC permitting it to clear such swaps for U.S. persons without being registered with the CFTC as a derivatives clearing organization. This is not included in the PRs' proposal.

	<b>CFTC Re-Proposal</b>	<b>Prudential Regulator Re-Proposal</b>	<b>BCBS / IOSCO Final Policy Framework</b>	<b>Comment</b>
<b>Initial Margin Methodology</b>	<p>Models, which must account for liquidation time horizon (99% confidence interval over a 10-day horizon); or</p> <p>Standardized table (allows for recognition of risk offsets through the use of a net-to-gross ratio in certain cases where portfolio of uncleared swaps is subject to same eligible master netting agreement).</p> <p>If models are available, choice of whether to use a model or standard calculation is made by the CFTC Covered Entity.</p>	<p>Same as CFTC, except PR Covered Entity must make consistent choices between a model and standardized schedule over time for all transactions within the same well-defined asset class (i.e. no “cherry picking”).</p>	<p>Models, which must account for liquidation time horizon (99% confidence interval over a 10-day horizon); or</p> <p>Standardized margin schedule (limited provisions for netting).</p> <p>Participants must make consistent choices between a model and schedule over time for all transactions within the same well-defined asset class (i.e. no “cherry picking”).</p>	<p>Consistent choice requirement distinguishes PR Regulator and BCBS/IOSCO from CFTC approach.</p>
<b>Variation Margin Methodology</b>	<p>Use a methodology and inputs that to the maximum extent practicable rely on recently-executed transactions, valuations provided by independent third parties, or other objective criteria;</p> <p>Have alternative methods available in the event of the unavailability or other failure of any input required to value a swap;</p> <p>Must calculate for risk management purposes a hypothetical variation margin requirement for each swap for</p>	<p>Not discussed.</p>	<p>Not discussed.</p>	

	<b>CFTC Re-Proposal</b>	<b>Prudential Regulator Re-Proposal</b>	<b>BCBS / IOSCO Final Policy Framework</b>	<b>Comment</b>
	<p>which the counterparty is a non-financial end user that has material swaps exposure to the CFTC Covered Entity as if the non-financial end user were a CFTC Covered Entity and compare that amount against any variation margin required pursuant to margin documentation;</p> <p>Create and maintain documentation setting forth the variation margin methodology with sufficient specificity to allow the counterparty, the CFTC and any applicable Prudential Regulator to calculate a reasonable approximation of the margin requirement independently; and</p> <p>Evaluate the reliability of its data sources at least annually and make adjustments as appropriate.</p>			
<b>Eligible Collateral</b>	<p>For variation margin:</p> <p>Only cash denominated in U.S. dollars or the currency in which payment obligations are required to be settled under the swap.</p> <p>For initial margin:</p> <ul style="list-style-type: none"> <li>• USD, major currency, or currency in which payment obligations under the swap are required to be settled;</li> <li>• U.S. Treasury securities;</li> </ul>	Basically the same as CFTC proposal.	<p>Should be highly liquid and able to hold value in periods of financial stress and includes but is not limited to:</p> <ul style="list-style-type: none"> <li>• Cash;</li> <li>• High-quality government and central bank securities;</li> <li>• High-quality corporate bonds;</li> </ul>	In contrast to CFTC's and PRs' proposals, the BCBS/IOSCO framework does not distinguish between forms of initial and variation margin.

	<b>CFTC Re-Proposal</b>	<b>Prudential Regulator Re-Proposal</b>	<b>BCBS / IOSCO Final Policy Framework</b>	<b>Comment</b>
	<ul style="list-style-type: none"> <li>• Other U.S. government agency securities;</li> <li>• U.S. government-sponsored enterprise debt securities subject to certain conditions</li> <li>• European Central Bank or certain sovereign entities' securities</li> <li>• Any security issued or fully guaranteed by the Bank for International Settlements, IMF, or a multilateral development bank;</li> <li>• Certain other securities; and</li> <li>• Gold</li> </ul>		<ul style="list-style-type: none"> <li>• High-quality covered bonds;</li> <li>• Equities included in major stock indices; and</li> <li>• Gold</li> <li>• Imposes haircuts</li> </ul>	
<b>Documentation</b>	Requires documentation with all counterparties, including non-financial end users, to provide clarity about the parties' respective rights and obligations, although the CFTC Covered Entity would be free to set initial margin and variation margin requirements, if any, with non-financial end users. Proposal cross references existing documentation requirements applicable to CFTC Covered Entities.	Similar to CFTC, but no requirement for PR Covered Entities with respect to documentation with non-financial end users.	No specific requirement for documentation.	
<b>Compliance Dates</b>	Variation margin requirements: December 1, 2015.  Initial margin requirements: Subject to phase-in from December 1, 2015 to December 1, 2019.	Same as CFTC.	Same as CFTC and PRs.	Consistent across all approaches.

	<b>CFTC Re-Proposal</b>	<b>Prudential Regulator Re-Proposal</b>	<b>BCBS / IOSCO Final Policy Framework</b>	<b>Comment</b>
<b>Margin requirements for swaps entered into before compliance dates</b>	<p>Requirements apply only to swaps entered into on or after applicable compliance date.</p> <p>Swaps entered into prior to compliance date that are covered by an eligible master netting agreement that covers swaps entered into on or after the compliance date must comply with requirements if CFTC Covered Entity calculates margin on an aggregate basis.</p>	Same as CFTC but applies to SBS as well.	Applies only to swaps entered into on or after the applicable compliance date.	CFTC and PRs' approach may discourage the use of master netting agreements, since it would apply margin requirements to pre-compliance date trades.

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