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Margin for Uncleared Swaps:

A Critical Look at the CFTC and Prudential Regulators Proposals

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Last fall both the Commodity Futures Trading Commission ("CFTC") and five U.S. prudential banking regulators[1] (the "Prudential Regulators") released proposed rules for margin requirements for uncleared swap transactions for the entities subject to their regulation (the proposed rules of the CFTC, the "CFTC Proposal,"[2] the proposed rules of the Prudential Regulators, the "Prudential Regulators Proposal,"[3] and the proposed rules, collectively, the "Proposals"). The margin requirements, when finalized, will play a significant role in determining the economics of the post-Dodd-Frank uncleared[4] swaps market, including the extent to which market participants may favor or disfavor uncleared swaps in comparison with other types of transactions. In a previous Client Alert, available here, we summarized the Proposals. In this Client Alert, we take a deeper look at the Proposals and highlight some of the many challenges that they would pose for market participants if implemented in their proposed form.

Both the CFTC[5] and the Prudential Regulators[6] released proposals for margin in 2011. Since that time, however, there has grown an international consensus around the policy framework for margin stated in a series of papers released by the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions, the last of which was published in September, 2013 (the "BCBS/IOSCO Framework").[7] With some significant exceptions, which we note below, the Proposals are broadly consistent both with the BCBS/IOSCO Framework and with each other.

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[1] The five prudential regulators include 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 Authority.

[2] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 Fed. Reg. 59898 (October 3, 2014).

[3] Margin and Capital Requirements for Covered Swap Entities, 79 Fed. Reg. 57348 (September 24, 2014).

[4] The CFTC Proposal refers to swaps that are not centrally cleared as "uncleared swaps," while the Prudential Regulators Proposal refers to such swaps as "non-cleared swaps." For consistency, we refer to them as "uncleared swaps."

[5] See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 23732 (April 28, 2011).

[6] See Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. 27564 (May 11, 2011).

[7] Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions, Margin requirements for non-centrally cleared derivatives (September 2013).

I. OVERVIEW OF PROPOSALS AND ISSUES ARISING FROM THEM

Although the Proposals by their terms apply directly to "covered swap entities" (each, a "CSE"),[8] the measures that they would require of CSEs would significantly change the economics of the uncleared swaps market not only for CSEs, but also for many of their financial counterparties. Among other things, the Proposals would:

- require CSEs to bilaterally exchange initial margin with other CSEs and with a broad range of financial end users whose use of swaps met a notional amount-based threshold ("material swaps exposure"), all such initial margin to be segregated and not subject to rehypothecation or other use;

- require CSEs to exchange variation margin with CSEs and with a broad array of financial end users (without regard to the existence of material swaps exposure);

- permit the calculation of initial margin by means of either a model-based method or a table-based method;

- permit offsets in relation to either initial margin calculations or variation margin calculations when (among other things) the offsets related to swaps that were subject to the same "eligible master netting agreement";

- require the use of cash as variation margin; and

- provide for staggered compliance dates ending in 2019 for initial margin, and apply to swaps transacted prior to a relevant compliance date if such swaps were subject to the same eligible master netting agreement as swaps transacted after such compliance date.

Among the issues for market participants that arise under the Proposals are the following:

- The Proposals would set the definition of "material swaps exposure," the aggregate notional amount at which initial margin requirements would become effective for financial end users, considerably lower than that suggested by the BCBS/IOSCO Framework. As a result, U.S. parties to swaps may be disadvantaged in comparison with non-U.S. market participants. See Part II.A.2 below.

- Several of the provisions contained in the Proposals would require CSEs to aggregate notional amounts with their affiliates. The aggregation requirement would affect not only the key "material swaps exposure" definition, but also the definition of "initial margin threshold" (the amount of initial margin below which no transfer of initial margin is required), and the phase-in schedule for initial margin. Affiliation for these purposes would be defined to be as little as 25 percent ownership or control. Aggregation of notional amounts exposures across diverse entities would be difficult to accomplish and would likely require the implementation of new systems. See Parts II.A.2, II.A.3 and VI.A below.

- The manner in which initial margin is proposed to be calculated may lead to misleadingly high calculations. The Proposals would require calculations based on an assumed close-out period of 10 business days, an assumed period expressly intended to disfavor uncleared swaps, and more prolonged than the period that most closeouts of uncleared swaps actually require. Further, the

[8] The Prudential Regulators Proposal, if finalized, would apply to "covered swap entities" including swap dealers (each, an "SD"), major swap participants (each, an "MSP"), security-based swap dealers and major security-based swap participants, in each case that is regulated by one of the Prudential Regulators. Prudential Regulators Proposal at 57350. The CFTC Proposal, if finalized, would apply to SDs and MSPs for which there is no Prudential Regulator. CFTC Proposal at 59902. We refer to "covered swap entities" as "CSEs" unless the context requires differentiation between CSEs for purposes of the CFTC Proposal and CSEs for purposes of the Prudential Regulators Proposal, in which case we refer to the CSEs covered by the Prudential Regulators Proposal as "Prudential Regulator CSEs" and to the CSEs covered by the CFTC Proposal as "CFTC CSEs."

Proposals restrict the nature of the offsets available in initial margin calculations by requiring each swap to be placed in one category and not permitting offsets even of truly like exposures across such categories. See Part II.B.1 below.

- The important definition of "eligible master netting agreement" contained in the Proposals, as well as the Proposals' requirement for custodial agreements for initial margin, would require CSEs to meet a poorly defined, but apparently heavy, due diligence burden. See Part II.B.3 below.

- The Proposals' requirement that variation margin be provided in the form of cash could help push swaps market liquidity into other jurisdictions and require investment managers to liquidate securities, thus causing tracking errors. See Part III.C below.

- The manner in which the Proposals may apply to pre-compliance date swaps would incentivize parties to negotiate new master netting agreements for new swaps and, thus, could increase risk rather than reduce it. See Part VI.B below.

II. INITIAL MARGIN REQUIREMENTS

Initial margin is intended to secure potential future exposure, that is, adverse changes in value that may arise during the period of time when a swap or group of swaps is being closed out.[9] Initial margin is to be provided within one business day after a swap is transacted[10] and is to augment the variation margin securing the current mark-to-market value of a swap or set of swaps. Outside of areas notable for their volatility (such as FX transactions, and especially exotic FX transactions), dealers have typically been hesitant to seek to impose on clients of demonstrable creditworthiness requirements for financial collateral beyond that reflecting current mark-to-market value. Under typical existing documentation for uncleared swaps published by the International Swaps and Derivatives Association, Inc. ("ISDA"), a requirement for collateral in excess of current mark-to-market value would likely be expressed as an "Independent Amount."[11]

The Proposals, in a significant break from historical practices for uncleared swaps, but in accordance with the BCBS/IOSCO Framework[12] and clearinghouse practices for cleared swaps, would require CSEs to both collect initial margin from and provide initial margin to many financial counterparties. Specifically, the Proposals would require the exchange of initial margin when (i) the notional amount of the swaps of a non-CSE financial counterparty and its affiliates reached a specified threshold ("material swaps exposure"), (ii) the initial margin calculation for swaps between the parties and their affiliates exceeded a separate threshold (the "initial margin threshold amount"), and (iii) a transfer was required with a value exceeding a specified minimum transfer amount. The mathematical basis upon which the Proposals would require CSEs to calculate initial margin is expressly intended to disfavor uncleared swaps. Unlike Independent Amounts under the ISDA Credit Support Annex, which typically form part of a calculation of a single value for which one party must provide collateral to the other,[13] initial margin for each applicable swap under the Proposals would be provided by each party to the other and segregated with an unaffiliated custodian.[14]

A. When Initial Margin is Required

Subject to an exposure threshold (the "initial margin threshold amount") and a minimum transfer amount, the CFTC Proposal would require each party to provide initial margin to the other party when the relevant swap was between (i) a CFTC CSE, and (ii) either a CSE or a "financial end user" with "material swaps

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[9] See, e.g., CFTC Proposal at 59901.
[10] CFTC Proposed Rule 23.152; Prudential Regulators Proposed Rule ___.3(c).
[11] See the preprinted form of Credit Support Annex, published in 1994 by ISDA (the "ISDA Credit Support Annex"), at paragraph 12 (defining "Independent Amount") and paragraph 3 (stating how Independent Amounts are to be used in calculations of collateral required to be exchanged).
[12] BCBS/IOSCO Framework at 4, 18-21.
[13] See ISDA Credit Support Annex at paragraph 3.
[14] See CFTC Proposed Rule 23.157; Prudential Regulators Proposed Rule ___.7.

exposure."[15] Similarly, subject to the same exposure threshold and minimum transfer amount, the Prudential Regulators Proposal would require each party to provide initial margin to the other party when the relevant swap or security-based swap was between (i) a Prudential Regulator CSE, and (ii) either a CSE or a "financial end user" with "material swaps exposure."[16] Accordingly, the only time when initial margin is not mandated[17] is when a party to a swap with a CSE is either (i) an end user that is not a "financial end user" or (ii) a financial end user that does not have "material swaps exposure."

1. Definition of "Financial End User"

The Proposals define "financial end user" as a party that is not a CSE, but which does fall within one of the 13 categories of entities engaged primarily in financial activities.[18] The categories are virtually identical in the CFTC Proposal and the Prudential Regulators Proposal. While the definition makes for notably dense reading, the categories can be summarized as follows:

- a wide variety of banks and bank-like institutions, both domestic and foreign;
- an entity that is state-licensed or registered as a credit or lending entity (other than entities registered or licensed solely on account of financing the entity's direct sales of goods or services to customers) or as a money services business;
- a securities holding company, broker or dealer, investment adviser or registered investment company;
- a private fund and certain investment company-like entities;
- a commodity pool, a commodity pool operator, a commodity trading advisor, or futures commission merchant;
- many employee benefit plans;
- an insurance company;
- an entity that is, or holds itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in loans, securities, swaps, funds or other assets for resale or other disposition or otherwise trading in loans, securities, swaps, funds or other assets;
- a foreign entity that would constitute a financial end user if it were organized under the laws of the United States or any State thereof; and
- any other entity that a relevant regulator determines should be treated as a financial end user.[19]

The "financial end user" definition expressly excludes from its scope sovereign entities,[20] multilateral development banks [21] the Bank for International Settlements, and a subset of financial entities that engage in swaps to hedge or mitigate commercial risks.[22]

[15] CFTC Proposed Rules 23.152 and 23.151 (definition of "Covered counterparty").
[16] Prudential Regulators Proposed Rule ___.3.
[17] See discussion of non-financial end users below at Part IV.
[18] See CFTC Proposed Rule 23.151 (definition of "Financial end user"); Prudential Regulators Proposed Rule ___.2 (definition of "Financial end user").
[19] See id.
[20] Sovereign entities are defined in the Proposals as a central government (including the U.S. government) or an agency, department, ministry, or central bank of a central government. See CFTC Proposed Rule 23.151 (definition of "sovereign entity"); Prudential Regulators Proposed Rule ___.2 (definition of "sovereign entity").
[21] The Proposals define the term multilateral development bank as the International Bank for Reconstruction and Development, the Multilateral Investment Guarantee Agency, the International Finance Corporation, the Inter-American Development Bank, the Asian

2. Definition of "Material Swaps Exposure"

Under the Proposals, an entity has "material swaps exposure" when it and its affiliates have an average daily aggregate notional amount of uncleared swap products (including swaps, security-based swaps, foreign exchange forwards and foreign exchange swaps[23]), calculated on business days falling in June, July and August of the previous year, that exceeds $3 billion.[24]

The regulators' proposed definition of "material swaps exposure" is proving controversial for several reasons. Equating materiality to an average aggregate notional amount of $3 billion is contrary to the BCBS/IOSCO Framework, which contains a far higher standard for materiality and, thus, would require initial margin for many fewer financial end users. In addition, market participants have expressed concern about the practicability of the requirement that exposure be measured at the corporate group level, across a party and its affiliates, especially in view of the Proposals' unusually loose definition of "affiliate." Further, it is not clear why the definition of material swaps exposure should take into account foreign exchange forwards and foreign exchange swaps, simple and often short-dated trades transacted in large quantities, which themselves are not subject to initial margin requirements.

a. Use of $3 Billion as Materiality Standard

The average notional amount that the regulators use to define materiality, $3 billion, is significantly lower than the average notional amount (€8 billion,[25] or, at the time at which the Proposals were released, approximately $11 billion[26]) by which the BCBS/IOSCO Framework defines materiality. The European regulators, in their draft regulatory technical standards pursuant to the European Market Infrastructure Regulation (the "EMIR RTS"), have also proposed to adopt the €8 billion threshold.[27] The U.S. regulators' lower number, if adopted, would require many more financial end users to provide initial margin than would be the case under the BCBS/IOSCO Framework or the EMIR RTS.[28]

Development Bank, the African Development Bank, the European Bank for Reconstruction and Development, the European Investment Bank, the European Investment Fund, the Nordic Investment Bank, the Caribbean Development Bank, the Islamic Development Bank, the Council of Europe Development Bank, 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 relevant Prudential Regulator or the CFTC determines poses comparable credit risk. See CFTC Proposed Rule 23.151 (definition of "Multilateral development bank"); Prudential Regulatory Proposed Rule ___.2 (definition of "Multilateral development bank") .

[22] See CFTC Proposed Rule 23.151 (definition of "Financial end user"); Prudential Regulator Proposed Rule __.2 (definition of "Financial end user").

[23] For these purposes, "foreign exchange forward" is defined as a transaction that solely involves the exchange of two different currencies on a specific future date at a fixed rate agreed upon on the inception of the contract covering the exchange, and "foreign exchange swap" is defined as a transaction that solely involves an exchange of two different currencies on a specific date at a fixed rate that is agreed upon on the inception of the contract covering the exchange and a reverse exchange of those two currencies at a later date and at a fixed rate that is agreed upon on the inception of the contract covering the exchange. See Commodity Exchange Act, 7 *U.S.C.* 1, *et seq.*, at Section 1a(24) and 1a(25). See also CFTC Proposed Rule 23.151 (definition of "Foreign exchange forward and foreign exchange swap"; Prudential Regulator Proposed Rule ___.2 (definition of "Foreign exchange forward and foreign exchange swap"). Because they settle by means of cross-exchanges of currencies rather than a single settlement payment from one party to another, foreign exchange forwards and foreign exchange swaps are also known as "physically settled" foreign exchange forwards and foreign exchange swaps.

[24] CFTC Proposed Rule 23.151 (definition of "Material swaps exposure"); Prudential Regulators Proposed Rule ___.2 (definition of "Material swaps exposure").

[25] BCBS/IOSCO Framework at 8, 24.

[26] See CFTC Proposal at 59905. However, at current exchange rates €8 billion is equal to approximately $9 billion, not $11 billion. Both the initial margin threshold amount ($65 million in the Proposals and €50 million in the BCBS/IOSCO Framework) and the minimum transfer amount ($650,000 in the Proposals and €500,000 million in the BCBS/IOSCO Framework) are based on an assumed exchange rate of 1.30 U.S. dollars to 1 Euro. However, at current exchange rates, the dollar equivalents of the initial margin threshold amount and minimum transfer amount stated in the BCBS/IOSCO are significantly lower than $65 million and $650,000. In the Proposals, the regulators request comment on whether and how fluctuations resulting from exchange rate movements should be addressed. See CFTC Proposal at 59901; Prudential Regulators Proposal at 57353.

[27] Consultation Paper – Draft regulatory technical standards on risk-mitigation techniques for OTC-derivatives contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012, April 14, 2014, at 5, 7.

[28] Another disparity between the approach of non-U.S. regulators and that of the CFTC and Prudential Regulators relates to the days on which the calculation for "materials swaps exposure" takes place. Under both of the Proposals, the existence of "material swaps exposure" is to be determined based on the average notional amounts calculated on business days falling in June, July and August of the previous year. See CFTC Proposed Rule 23.151 (definition of "Material swaps exposure"); Prudential Regulators Proposed Rule ___.2 (definition of "Material swaps exposure"). In contrast, under the BCBS/IOSCO Framework, notional amounts

The CFTC and the Prudential Regulators explain the substantial disparity between $3 billion and $11 billion by reference to what they believe to be the intention of international regulators. They state that the intent of the BCBS/IOSCO Framework is to require collection of initial margin when the amount exceeds the initial margin threshold amount ($65 million in the Proposals); and, based on a review of data for cleared swaps, which the regulators deem to entail less risk than bilateral swaps, the regulators believe that there are many "cases in which a financial end user would have a material swaps exposure level below $11 billion but would have a swap portfolio with an initial margin collection amount that significantly exceeds the proposed permitted initial margin threshold amount of $65 million."[29] The $3 billion number, multiplied by what the regulators claim to be the average initial margin rate in the cleared swaps market of 2.1 percent of gross notional amount,[30] equals $63 million, just short of the proposed $65 million initial margin threshold. Accordingly, the U.S. regulators took the "preliminary view" that $3 billion is an appropriate threshold to determine when a financial end user's swaps exposure is material and should require the exchange of initial margin.[31]

That the U.S. regulators have correctly ascertained the intent of the BCBS/IOSCO Framework is by no means clear. The BCBS/IOSCO Framework states both that (i) "[a]ll covered entities must exchange, on a bilateral basis, initial margin with a threshold not to exceed €50 million"[32], and (ii) "there will be a minimum level of non-centrally cleared OTC derivatives activity (€8 billion in gross notional outstanding amounts) necessary for covered entities to be subject to initial margin requirements described in this paper."[33] The framework does not appear to recognize any tension that might exist between these two statements, and indeed appears to state them as independent requirements. In fact, it seems plain that the BCBS/IOSCO Framework adopted the $65 million initial margin threshold amount to alleviate liquidity concerns arising from initial margin requirements, not to determine which parties should be subject to initial margin requirements.[34]

In any event, many market participants see peril in the possibility of a $3 billion materiality threshold for initial margin. Some have noted that, if the U.S. regulators were to adopt a different standard for "material swaps exposure" than is adopted in other countries, U.S. companies and their affiliates could be hamstrung in comparison with companies with no ties to the U.S.[35] Similarly, others view a common threshold for "material swaps exposure" as necessary for international harmonization,[36] and warn that a disparity between U.S. and non-U.S. definitions could contribute to further swaps market fragmentation.[37]

b. Aggregating Exposures Among Affiliates

The Proposals define "material swaps exposure" as the aggregate notional amount of swaps not only of a particular entity, but also of its affiliates. As a result, under the Proposals, in order to determine whether "material swaps exposure" exists, financial end users would be required to determine the overall notional amount of both their swaps and those of their affiliates. In this regard, the definition is aligned with both the BCBS/IOSCO Framework and the EMIR RTS.[38]

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are to be determined based on the average notional amounts calculated at the end of each of June, July and August. BCBS/IOSCO Framework at 23-24. See also EMIR RTS at 46.

[29] CFTC Proposal, 79 Fed. Reg. at 59905; Prudential Regulators Proposal, 79 Fed. Reg. at 57367.

[30] See id.

[31] CFTC Proposal, 79 Fed. Reg. at 59905; Prudential Regulators Proposal, 79 Fed. Reg. at 57366-67.

[32] See note 26 above and discussion at Part II.A.3.

[33] BCBS/IOSCO Framework at 9.

[34] See BCBS/IOSCO Framework at 8 ("One method for managing the liquidity impact associated with initial margin requirements—and one that has received broad support—is to provide for an initial margin threshold (threshold) that would specify an amount under which a firm would have the option of not collecting initial margin."); comment letter of the Investment Company Institute, dated September 24, 2014 (the "ICI Letter"), at 7, note 15.

[35] See, e.g., comment letter of the Asset Management Group of the Securities Industry and Financial Markets Association, dated November 24, 2014, (the "SIFMA Letter") at 12.

[36] ICI Letter at 7.

[37] Comment letter of the Coalition for Derivatives End-Users, dated December 2, 2014, at 8.

[38] BCBS/IOSCO Framework at 10, 24; EMIR RTS at 46.

However, market participants have expressed significant concerns regarding the potential necessity of aggregating their notional amounts with those of their affiliates. Calculations of aggregated swaps exposures could prove difficult for financial end users and their affiliates to implement and could require expensive new reporting and tracking systems.[39] Further, requiring financial end users to aggregate transactions of their non-financial affiliates could potentially penalize financial end users with relatively little swaps trading activity.[40]

The difficulties that enterprises might have in tracking notional amounts across entities would likely be exacerbated by the unusually low level of "control" that the Proposals would require for an affiliation to exist. The "control" necessary for a company to be an "affiliate" of another company is defined loosely, as (a) only 25 percent (not 50 percent or more) of the ownership or control, directly or indirectly, of (i) a class of voting securities or (ii) the total equity, directly or indirectly, or (b) control in any manner of the election of a majority of the directors or trustees of the company.[41] This definition of "control" means that entities with relatively low levels of affiliation would, under the Proposals, be required to work together to determine the notional amounts of their swaps.

Implementing the aggregation of notional amounts across affiliates, as so defined, could pose particular difficulties in the context of investment vehicles and asset management. For example, a large institutional investor such as a pension plan might own more than 25 percent of an investment vehicle and, thus, be required to aggregate the positions of the investment vehicle with its own swaps to determine overall swaps exposure.[42] Moreover, aggregation of all of an investor's swaps appears to be incongruent with the typical practice, in the asset management context, of separating assets into different pools managed by different managers, with recourse of any counterparty limited to the particular assets in relation to which the manager has entered into a swap.[43] Accordingly, some have argued, investment funds and certain other investment vehicles should be exempted from any aggregation requirement.[44]

c. Inclusion of FX Transactions in Determination of "Material Swaps Exposure"

The notional amounts used to calculate whether a party has "material swaps exposure" include the notional amounts of simple foreign exchange transactions—foreign exchange forwards and foreign exchange swaps[45]—that do not qualify as "swaps" for many purposes and for which no initial margin is required.[46] The inclusion of such forwards and swaps in such calculation is in accordance with the BCBS/IOSCO Framework.[47]

However, market participants have commented that requiring foreign exchange forwards and foreign exchange swaps to be aggregated for purposes of determining the existence of material swaps exposure would unduly increase costs for counterparties who use such products heavily, but use other derivatives only sparingly.[48] It is not wholly clear why such products, which are often short-dated, and which do not themselves require any initial margin, should be aggregated for purposes of determining whether material swaps exposure exists.[49]

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[39] SIFMA Letter at 7.
[40] Comment letter of the Committee on Investment of Employee Benefit Assets, dated November 24, 2014 (the "CIEBA Letter"), at 9-10.
[41] See CFTC Proposed Rule 23.151 (definitions of "Affiliate" and "Control"); Prudential Regulators Proposed Rule ___.2 (definitions of "Affiliate" and "Control").
[42] See CIEBA Letter at 6; SIFMA letter at 7.
[43] SIFMA Letter at 9.
[44] SIFMA Letter at 8. See also ICI Letter at 9-10.
[45] See note 23 above.
[46] The Proposals do not contain margin requirements for foreign exchange forwards and foreign exchange swaps, in keeping with the Secretary of the Treasury's determination to exempt such transactions from most provisions of the Commodity Exchange Act, including margin requirements. See Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, 77 Fed. Reg. 69694 (November 20, 2012). See also Part III.D below.
[47] BCBS/IOSCO Framework at 24.
[48] SIFMA Letter at 14-15; CIEBA Letter at 12-13.
[49] See CIEBA Letter at 13.

3. Initial Margin Threshold Amount and Minimum Transfer Amount

The posting of initial margin is subject to an "initial margin threshold amount" of $65 million, which, in accordance with the BCBS/IOSCO Framework,[50] is to apply on a consolidated entity level, across each party and its affiliates in respect of all uncleared swaps and security-based swaps.[51] The initial margin threshold amount reduces any initial margin that is required to be posted by a party. If the initial margin requirement is less than the initial margin threshold amount, then there is no requirement to post initial margin.[52]

The application of the threshold amount across each party and its affiliates raises similar concerns as does the aggregation of swaps exposures across affiliates for purposes of "material swaps exposure" (see Part II.A.2.b above). Especially in view of the low 25 percent requirement for affiliation, the application of the initial margin threshold amount across all affiliates would, in practice, likely prove difficult and costly to implement.[53]

Under both Proposals a CSE is not required to collect or post any amount below the minimum transfer amount of USD $650,000.[54]

B. Calculation of Initial Margin

Under both Proposals, a CSE must calculate the required amount of initial margin daily, on the basis of either a risk-based model or a table-based method.[55] The regulatory requirements for risk-based models are significant.

In relation to risk-based models, market participants have noted several aspects of the calculation of initial margin in the Proposals that could prove disadvantageous or problematic. The Proposals would require models to calculate initial margin amounts on the basis of a 10-day close-out period, a hypothetical period that is expressly intended to disfavor uncleared transactions and is longer than the period that actual close-outs typically require under standard documentation for uncleared swaps. In addition, the Proposals would limit, arguably artificially, the extent to which initial margin models would be permitted to reflect offsetting exposures.

Of relevance to both risk-based models and the table-based method is the regulators' definition of "eligible master netting agreement," which would place an ill-defined, but potentially heavy, burden of due diligence on CSEs, who would be required to verify the treatment of netting agreements under all relevant insolvency regimes.

1. Risk-Based Model

The regulators' requirements for risk-based models include the following.

a. Ten Business Day Close-Out Period

Under both Proposals, a risk-based model used by a CSE would generally calculate initial margin based on the assumption of a "holding period" of 10 business days.[56] This is the period for which the initial margin required by the Proposals would be intended to mitigate risk, which, in theory, at least, should correspond to the period when a swap or set of swaps is in the process of being closed out. The amount

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[50] See BCBS IOSCO Framework at 9.
[51] See CFTC Proposed Rule 23.151 (definition of "Initial margin threshold amount"); Prudential Regulators Proposed Rule ___.2 (definition of "Initial margin threshold amount").
[52] See CFTC Proposed Rule 23.154(a); Prudential Regulators Proposed Rule ___.3(a).
[53] SIFMA Letter at 7.
[54] See CFTC Proposed Rule 23.151 (definition of "Minimum transfer amount"); Prudential Regulators Proposed Rule ___.5(a).
[55] See CFTC Proposed Rule 23.154(a); Prudential Regulators Proposed Rule ___.3 and Proposed Rule ___.2 (definition of "Initial margin collection amount").
[56] CFTC Proposal at 23.154(b)(3)(i); Prudential Regulators Proposal at __.8(d)(1).

of initial margin would be calculated as an amount equal to an estimate, for that period, "of the one-tailed 99 percent confidence interval for an increase in the value… due to an instantaneous price shock that is equivalent to a movement in all material underlying risk factors, including prices, rates, and spreads."[57] A model-based method would be required to use "risk factors sufficient to measure all material price risks inherent in the transactions for which initial margin is being calculated."[58] The data used to calibrate the model would be based on an equally weighted historical observation period of at least one year and not more than five years and would incorporate a period of significant financial stress for each broad asset class related to the relevant swaps.[59]

The assumed length of the close-out period is of critical importance to the calculation of initial margin; the longer the assumed close-out period, the greater the initial margin amount. The regulators' proposed ten-business-day liquidation horizon, which is longer than the 10-day horizon (apparently calendar days, not business days) contemplated by the BCBS/IOSCO Framework,[60] is expressly intended to disfavor uncleared swaps relative to cleared swaps. According to the CFTC Proposal, by requiring "ten day initial margins for uncleared swaps and only five day margin for cleared swaps," the Proposals "make cleared swaps relatively more attractive."[61] This explanation, however, understates the extent of the regulators' favoritism of cleared swaps. Many cleared swaps, namely those on agricultural commodities, energy commodities, and metals, are permitted minimum liquidation times of only one day.[62] Further, for cleared swaps, market participants can request,[63] and have requested,[64] that assumed close out periods be reduced.

A ten-business-day close-out period, moreover, appears to be materially longer than the usual close-out period for most uncleared swaps. A typical close-out period under an ISDA Master Agreement, the most-used master netting agreement in the uncleared swaps market, might reasonably be expected to require approximately four to six business days, a period that takes into account of the cure period, typically of one or three business days,[65] to cure a failure to pay or deliver, as well as the time required to deliver notices and value outstanding transactions. One CFTC Commissioner, in requesting a "considered analysis" of the effects of a ten-business-day period, stated that he was "troubled by recent press reports of remarks by unnamed Fed officials that the coverage period may be intentionally 'punitive' in order to move the majority of trades into a cleared environment."[66] Market participants have contended that the proposed ten-business-day liquidation time is too long for purposes of determining initial margin amounts, and should be shortened to closer to five days[67] or even shorter.[68]

b. Restrictions on Use of Offsets in Calculations of Initial Margin

The Proposals restrict the extent to which a risk-based model may reflect offsetting exposures that would reduce the required amount of initial margin. A risk-based model for initial margin would be permitted to recognize an offsetting exposure for a swap only in relation to another swap that falls within the same category, and not in relation to another swap that falls within another category.[69]

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[57] CFTC Proposal at 23.154(b)(3)(i); Prudential Regulators Proposal at __.8(d)(1).
[58] CFTC Proposal at 23.154(b)(3)(iii); Prudential Regulators Proposal at __.8(d)(3).
[59] CFTC Proposal at 23.154(b)(3)(ii); Prudential Regulators Proposal at __.8(d)(2).
[60] BCBS/IOSCO Framework at 11.
[61] CFTC Proposal at 59924.
[62] CFTC Rule 39.13(g)(2)(ii)(B).
[63] See CFTC Rule 39.13(g)(2)(ii)(D).
[64] See, e.g., letter to CFTC of Javelin SEF, LLC, dated December 3, 2014, requesting that the minimum liquidation time for certain interest rate swaps be shortened from five days to one day.
[65] The 2002 version of the ISDA Master Agreement provides a one-business-day cure period for an event of default based on a failure to make a required payment or delivery. See ISDA 2002 Master Agreement at Section 5(a)(i). The 1992 version of the ISDA Master Agreement provides a three-business-day cure period for an event of default based on a failure to make a required payment or delivery. See ISDA Master Agreement (Multicurrency—Cross-Border) at Section 5(a)(i). The parties to such an agreement may agree to amend any applicable cure period.
[66] CFTC Proposal at 59934-35 (Appendix 3—Statement of Commissioner J. Christopher Giancarlo).
[67] SIFMA Letter at 28.
[68] CIEBA Letter at 14.
[69] CFTC Proposal at 23.154(b)(3)(v); Prudential Regulators Proposal at __.8(d)(5).

The categories of swaps within which offsets are permitted include agriculture, credit, energy, equity, foreign exchange/interest rate, metals, and other.[70] Under the Proposals, even truly like exposures could not be offset across such categories. For example, CSEs would not be able to offset interest rate exposures arising from interest rate swaps against interest rate exposures arising either from the financing legs of equity swaps or the fixed rate side of credit default swaps.[71] Although the regulators' unwillingness to permit risk offsets across different asset classes is consistent with the BCBS/IOSCO Framework,[72] some market participants have commented that broader risk offsets should be permitted if there is a sound basis and empirical support for them.[73] For each party to an eligible master netting agreement, under the Proposals the overall amount of initial margin required would be calculated based on the sum of the initial margin amounts for swaps in each of the seven categories.

c. Regulatory Approvals and Required Internal Processes for Models

Each risk-based model used to calculate initial margin would be subject to regulatory approval. A CSE would be required to obtain the written approval of the relevant regulator in order to use a risk-based model to calculate initial margin, and to demonstrate, on an ongoing basis, that the model satisfies all of the regulators' requirements.[74] Before making any material change to its risk-based model or its assumptions, or extending the use of an approved initial margin model to any additional products, a CSE would be required to give 60 days' prior notice to the relevant regulator.[75] The relevant regulator could rescind its approval of any initial margin model, or impose additional conditions or requirements, if the regulator were to determine that the model was no longer fully compliant.[76]

The Proposals would require each CSE to have a rigorous and well-defined process to re-evaluate and update its internal models to ensure continued applicability and relevance, and to review and, as necessary, revise the data used to calibrate the model at least monthly, or more often if warranted by market conditions.[77] At least annually, each CSE would be required to review its model in light of developments in financial markets and modeling technologies, and to enhance the model as appropriate to ensure that it continues to meet the regulatory requirements.[78] Each CSE's risk control unit would be required to validate the CSE's model prior to implementation and on an ongoing basis.[79] The Proposals would require CSEs to notify the relevant regulator of any problems that their validation process might uncover, and to document all material aspects of their risk-based models.[80]

2. Table-Based Method

In accordance with the BCBS/IOSCO Framework,[81] under the Proposals, CSEs have the option to employ a table-based method for calculating initial margin rather than a risk-based model.

The Prudential Regulators state that Prudential Regulator CSEs should not choose between a risk-based model and the table-based method by "cherry picking" the approach that requires the lower initial margin level. Rather, they state, the choice of one method over the over "should be based on fundamental considerations," and, absent a significant change in swap activities, they do not consider that it should be necessary for Prudential Regulator CSEs to switch between using a risk-based model and a table-based

[70] CFTC Proposal at 23.154(b)(3)(v); Prudential Regulators Proposal at __.8(d)(5).
[71] See CFTC Proposal at 59910 (acknowledging that equity and credit swaps may have sensitivity to interest rates and requesting comment on its categorization of swaps).
[72] BSBC/IOSCO Framework at 12.
[73] SIFMA Letter at 26.
[74] CFTC Proposed Rule 23.154(b)(i) and (ii), and Prudential Regulators Proposed Rule ___.8(c)(1) and (2).
[75] CFTC Proposed Rule 23.154(b)(iii), and Prudential Regulators Proposed Rule ___.8(c)(3).
[76] CFTC Proposed Rule 23.154(b)(iv), and Prudential Regulators Proposed Rule ___.8(c)(4).
[77] CFTC Proposed Rule 23.154(b)(3)(xii) and (xiii), and Prudential Regulators Proposed Rule ___.8(d)(12) and (13).
[78] CFTC Proposed Rule 23.154(b)(4) and Prudential Regulators Proposed Rule ___.8(e).
[79] CFTC Proposed Rule 23.154(b)(5) and Prudential Regulators Proposed Rule ___.8(f).
[80] CFTC Proposed Rule 23.154(b)(5)(iii) and (6), and Prudential Regulators Proposed Rule ___.8(f)(3) and (g).
[81] BSBC Framework at 11.

method.[82] The CFTC Proposal contains no such statement, but it does note the BCBS/IOSCO Framework's statement that covered entities should not "cherry pick" between methods.[83]

The tables forming the basis of the table-based method are included in the Proposals. The charts in the CFTC Proposal and the Prudential Regulators Proposal are aligned, with the initial margin requirements ranging from 1 percent of notional amount (for short-dated interest rate swaps and cross-currency swaps) to as high as 15 percent of notional amount (for commodity swaps, equity swaps, and swaps in the "other" category).[84]

For multiple uncleared swaps subject to the same eligible master netting agreement, the initial margin amount is to be computed according to a formula[85] that relies, in part, on the net current replacement cost of all relevant swaps and, thus, partially reflects the degree to which such uncleared swaps offset each other.[86]

3. Eligible Master Netting Agreements

Both the formula employed in the table-based method and the approach of the risk-based model to reflect offsetting exposures require that offsets be reflected only for swaps that are subject to the same "qualifying master netting agreement." This term is defined in a manner that would impose on CSEs a sketchily defined, but apparently heavy, burden of due diligence.

The Proposals define an "eligible master netting agreement" as a written, legally enforceable agreement, that, among other things:

- creates a single legal obligation for all individual transactions covered by the agreement upon an event of default, including an insolvency-related event of default;

- provides the CSE with the right to accelerate, terminate, and close out on a net basis all transactions under the agreement and to liquidate or set off collateral promptly upon an event of default of the counterparty, subject to applicable law relating to the close-out of transactions against banks and systemically important institutions;

- does not contain a "walkaway clause" permitting a non-defaulting counterparty to make a lower payment than it otherwise would make under the agreement, or no payment at all, to a defaulting party; and

- has been subject to sufficient legal review by the CSE (which is required to establish and maintain written procedures to ensure that the agreement continues to satisfy the regulators' requirements) that the CSE may conclude with a well-founded basis that the agreement

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[82] Prudential Regulators Proposal at 57378.
[83] CFTC Proposal at 59900.
[84] See CFTC Proposed Rule 23.154(c), and Prudential Regulators Proposed Rule ___.8(a) (definition of "Initial margin collection amount" and Appendix A, Table A.
[85] The formula is as follows:

Standardized Initial Margin = 0.4 × Gross Initial Margin + 0.6 × NGR × Gross Initial Margin

Where:

Gross Initial Margin = the sum of the notional value multiplied by the appropriate initial margin requirement percentage from the table contained in the Proposals for each uncleared swap subject to the relevant eligible master netting agreement; and

NGR = net-to-gross ratio, which compares (i) in the numerator, the net current replacement cost of the entire uncleared portfolio subject to an eligible master netting agreement with (ii) in the denominator, the gross current replacement cost of only swaps contained in the uncleared portfolio subject to an eligible master netting agreement that have a positive replacement cost.

See Prudential Regulators Proposal at 57377 and 57396 (Table A); CFTC Proposal at 59911-12 and Proposed Rule 23.154(c).
[86] See CFTC Proposal at 59911 and note 82.

constitutes an eligible master netting agreement and, in the event of a legal challenge, including an insolvency-related proceeding, would be ruled to be legal, valid, binding, and enforceable under the law of the relevant jurisdictions.[87]

It is the last of these requirements, the legal review with respect to enforceability, including insolvency, that has raised the most concern. In some cases it may not be wholly clear which jurisdictions are "relevant" for purposes of such legal review.[88] And then there is the further question of what type of legal review qualifies as "sufficient"; if a "sufficient legal review" in practice means obtaining an opinion of counsel, then the requirement could, in practice, adversely affect costs for dealers and, ultimately, for their counterparties.[89] Further questions would arise concerning the assumptions and qualifications that would be permissible in such opinions. Moreover, for certain counterparty types, such as ERISA funds, it may be impossible to obtain a strong opinion of counsel because the extent to which close-out netting applies to such counterparties may be unclear.[90] Rather than requiring a legal review of uncertain scope, some market participants have suggested, the regulators should require disclosure of insolvency-related risks, or require only that a reasonable basis exists to conclude that agreements will be enforceable.[91]

C. Forms of Initial Margin

Unlike with variation margin (see discussion at Part III.C below), a wide variety of assets may be posted as initial margin. Indeed, the list of assets eligible to be posted as initial margin is more inclusive than has been the typical practice in the uncleared swaps market. Both Proposals would permit the following assets as initial margin:

- U.S. dollars, numerous other major currencies, and a currency in which payments under the relevant swap are required to be made;
- a security issued by, or unconditionally guaranteed by, the U.S. Department of the Treasury or another U.S. government agency whose obligations are fully guaranteed by the full faith and credit of the United States government;
- a publicly traded debt security issued by, or an asset-backed security fully guaranteed by, a U.S. Government-sponsored enterprise operating with direct financial assistance received from the U.S. government enabling the repayments of the U.S. Government-sponsored enterprise's eligible securities;
- a security issued by, or fully guaranteed by, the European Central Bank or certain sovereign entities;
- a security issued by, or fully guaranteed by, the Bank for International Settlements, the International Monetary Fund, or a multilateral development bank;
- publicly traded common equity that is included in either (i) the S&P Composite 1500 Index or any other similar index of liquid and readily marketable equity securities as determined by the relevant regulator, or (ii) an index that a CSE's supervisor in a foreign jurisdiction recognizes for purposes of initial margin; and
- gold.[92]

However, initial margin may not consist of a security that is issued by (i) the party pledging the security of an affiliate of that party; or (ii) a bank holding company, a savings and loan holding company, a foreign

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[87] CFTC Proposed Rule 23.151(definition of "Eligible master netting agreement") and Prudential Regulators Proposed Rule ___.2 (definition of "Eligible master netting agreement").
[88] ICI Letter at 20.
[89] SIFMA Letter at 19; ICI Letter at 20.
[90] SIFMA Letter at 19.
[91] SIFMA letter at 18-20.
[92] CFTC Proposed Rule 23.156(a)(1); Prudential Regulators Proposed Rule ___.6(a). The Prudential Regulators Proposal also includes a provision for publicly-traded debt, including a debt security by a U.S. Government-sponsored enterprise ("GSE") (not otherwise covered by the GSE provision) that has adequate capacity to meet financial commitments (as defined by the appropriate Prudential Regulator) and is not an asset-backed security. See Prudential Regulators Proposal at 57371-72; ___.6(a)(2)(vii)(A). The CFTC Proposal includes a provision for publicly-traded debt that has been deemed acceptable as initial margin by a Prudential Regulator. See CFTC Proposed Rule 23.156(a)(1)(ix).

bank, a depository institution, a market intermediary, a company that would be any of the foregoing if it were organized under the laws of the United States or any State, or an affiliate of any of the foregoing institutions.[93]

Initial margin is subject to proposed standardized haircuts ranging from zero (in the case of cash in the same currency as the related swap) to 25 percent (in the case of certain equities).[94]

D. Segregation of Initial Margin

Both Proposals require the segregation of initial margin. A CSE that posts or collects initial margin in relation to uncleared swaps must require that such margin be held by one or more custodians that are not affiliates of either the CSE or the counterparty.[95] Under both Proposals, the relevant custodial agreement must prohibit the custodian from rehypothecating or otherwise transferring the initial margin held by it. However, a custody agreement may, if all relevant assets remain eligible as initial margin and of sufficient value, permit the posting party to substitute or direct any reinvestment of initial margin held by the custodian.[96]

The custodial agreement must be legal, valid, binding and enforceable under the laws of all relevant jurisdictions including in the event of bankruptcy, insolvency, or a similar proceeding.[97] As with the definition of "eligible master netting agreement" (see Part II.B.3 above), this definition gives rise to concerns that it may be difficult to identify all relevant jurisdictions, that, in order to evidence fulfillment of this requirement, it may be necessary to obtain opinions of counsel, and that, if opinions of counsel are indeed required, the exact parameters of those opinions are unclear.[98] In addition, the proposed requirement that custodians not be affiliated with either party also raises concerns for end users, which often have at least one custodian affiliated with a dealer,[99] and particularly for pension plans, which often use their trustees, or affiliates of their trustees, as custodians.[100]

III. VARIATION MARGIN

A. Variation Margin Generally

Subject to the $650,000 minimum transfer amount, the CFTC Proposal would require one party to provide variation margin to the other party when the relevant swap is between (i) a CFTC CSE, and (ii) either a CSE or a financial end user.[101] Similarly, subject to the same minimum transfer amount, the Prudential Regulators Proposal would require one party to provide variation margin to the other party when the relevant swap or security-based swap is between (i) a Prudential Regulator CSE, and (ii) either a CSE or a financial end user.[102] Accordingly, the only time when variation margin is not mandated[103] is when a party to a swap with a CSE is an end user that does not constitute a financial end user. In requiring variation margin for all financial end users, regardless of whether the entity has material swaps exposure, the Proposals are consistent with the BCBS/IOSCO Framework.[104]

The Proposals permit netting arrangements across swaps for purposes of calculating variation margin amounts only if the relevant swaps are subject to the same "eligible master netting agreement."[105] This raises concerns regarding the definition of such term noted in the discussion at Part II.B.3 above.

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[93] CFTC Proposed Rule 23.156(a)(2); Prudential Regulators Proposed Rule ___.6(c).
[94] CFTC Proposed Rule 23.156(a)(3); Prudential Regulators Proposed Rule ___.6(b).
[95] CFTC Proposed Rule 23.157(a) and (b); Prudential Regulators Proposed Rule ___.7(a) and (b).
[96] CFTC Proposed Rule 23.157(c); Prudential Regulators Proposed Rule ___.7(c)(1) and (d).
[97] CFTC Proposed Rule 23.157(c)(3); Prudential Regulators Proposed Rule ___.7(c)(2).
[98] SIFMA Letter at 19; CIEBA Letter at 10-11.
[99] SIFMA Letter at 22.
[100] CIEBA Letter at 8-9.
[101] CFTC Proposed Rule 23.153(a).
[102] Prudential Regulators Proposed Rule ___.4(a).
[103] See discussion of non-financial end users at Part IV below.
[104] BCBS/IOSCO Framework at 9.
[105] CFTC Proposed Rule 23.153(c); Prudential Regulators Proposed Rule ___.4(d).

B. Calculation of Variation Margin

The CFTC Proposal and the Prudential Regulators Proposal appear to differ from each other in the amounts that they would require to be exchanged as variation margin. It is not clear that this difference is intentional. In any case, there does not appear to exist a compelling reason for which variation margin amounts should differ for Prudential Regulator CSEs and CFTC CSEs.

Under the Prudential Regulators Proposal, variation margin is apparently to be measured from the standpoint of the CSE, that is, at the CSE's side of the market: a CSE must calculate variation margin as an amount that is at least equal to the increase or decrease (as applicable) in the value to the CSE of the relevant swaps since the previous exchange of variation margin.[106] This formulation, intentionally or not, echoes the ISDA Master Agreement's definition of "Market Quotation," which is intended to provide for calculations at one party's side of the market, as the amount that would have the effect of preserving for such party the economic equivalent of a transaction.[107] If the Prudential Regulators were to adopt this formulation in their final rulemaking, then counterparties of Prudential Regulator CSEs could be undercollateralized in the event of a Prudential Regulator CSE's default, because they could be collateralized only at the Prudential Regulator CSE's side of the market.

The CFTC's formulation of the required amount of variation margin includes no such requirement, and provides little guidance as to whether, for purposes of variation margin, swaps are to be valued at one party's side of the market or, in accordance with typical practice in the uncleared market,[108] at mid-market. The CFTC would require a CFTC CSE to use a variation margin methodology and inputs that to the maximum extent practicable rely on recently-executed transactions, valuations provided by independent third parties, or other objective criteria, and to have alternative methods available in the event of the unavailability or other failure of any input required to value a swap.[109] The CFTC Proposal also contains "control mechanisms" that would require CFTC CSEs to create and maintain documentation setting forth the variation margin methodology with sufficient specificity to allow the CFTC CSE's counterparty and any applicable regulator to calculate a reasonable approximation of the margin requirement independently.[110] CSEs would be required to evaluate the reliability of their data sources at least annually and to make adjustments as appropriate. The CFTC's proposal also includes a provision authorizing the CFTC to require a CSE at any time to provide further data or analysis concerning the variation margin methodology or data source.[111]

C. Forms of Variation Margin

Under both Proposals, variation margin must be collected in cash, which may be denominated in U.S. dollars or in the currency in which payment obligations under the swap are required to be settled.[112] Because variation margin payments are to be made in cash, the Proposals impose no haircuts on variation margin. The Proposals limit forms of variation margin far more strictly than do the BCBS/IOSCO Framework and the EU Margin RTS, which do not distinguish forms of initial and variation margin, and,

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[106] Prudential Regulators Proposed Rule __.2 (definition of "Variation margin amount"). More specifically, under Prudential Regulators Proposed Rule __.2, the variation margin amount to be exchanged is equal to "the cumulative mark-to-market **change in value to a covered swap entity** of a non-cleared swap or non-cleared security-based swap, as measured from the date it is entered into (or, in the case of a non-cleared swap or non-cleared security-based swap that has a positive or negative value to a covered swap entity on the date it is entered into, such positive or negative value, plus any cumulative mark-to-market **change in value to the covered swap entity** of a non-cleared swap or non-cleared security-based swap after such date), less the value of all variation margin previously collected, plus the value of all variation margin previously paid with respect to such non-cleared swap or non-cleared security-based swap" (emphasis added).
[107] See ISDA Master Agreement (Multicurrency—Cross-Border) at Section 14 (definition of "Market Quotation"); see also 2002 ISDA Master Agreement at Section 14 (defining "Close-out Amount," in part, as an amount intended to provide one party with the economic equivalent of a transaction's material terms).
[108] See ISDA Credit Support Annex at Paragraphs 12 (definition of "Exposure") and 3.
[109] CFTC Proposed Rule 23.155(a).
[110] See CFTC Proposed Rule 23.155(b).
[111] Id.
[112] CFTC Proposed Rule 23.156(b); Prudential Regulators Proposed Rule ___.6(a). Eligible variation margin "cash" does not include major currencies other than the U.S. dollar, as is the case for initial margin.

thus, contemplate that variation margin may be provided in a variety of highly liquid forms, including high quality government or corporate bonds and equities in major stock indices.[113]

The CFTC justifies restricting variation margin to cash based on its questionable understanding that swap counterparties generally view exchanges of variation margin as "the daily settlement of their exposure(s) to one another."[114] This justification appears to run contrary to the actual workings of the uncleared swaps market, in which parties typically transfer highly liquid securities, such as U.S. Treasury obligations, by way of security for their mark-to-market obligations to each other. The narrower scope of variation margin in the U.S. could push swaps market liquidity away from the U.S. and into other markets.[115] Further, in the case of investment managers whose returns are based on staying fully invested in securities, the requirement to post only cash as variation margin could require the liquidation of investments, thus causing tracking errors, and in certain cases could even introduce currency basis risk.[116]

D. Treatment of Foreign Exchange Swaps and Forwards

By its terms, the BCBS/IOSCO Framework applies to all uncleared derivatives other than foreign exchange forwards and foreign exchange swaps; with respect to such transactions, the BCBS/IOSCO Framework states, variation margin standards should be addressed by national supervisors in a manner consistent with BCBS supervisory guidance recommendations for these products.[117]

One of the Prudential Regulators, the Board of Governors of The Federal Reserve System, has implemented such BCBS supervisory guidance by means of a letter applicable to large financial institutions subject to its supervision.[118] That letter states its support of the principles contained in the guidance and, thus, affirms that such institutions should, as stated in the supervisory guidance, exchange "the full amount of variation margin necessary to fully collateralise the mark-to-market exposure on physically settling FX swaps and forwards with counterparties that are financial institutions and systemically important non-financial entities."[119]

IV. TREATMENT OF NON-FINANCIAL END USERS

The Proposals differ from each other somewhat in their treatment of non-financial end users.

Under the Prudential Regulators Proposal, a Prudential Regulator CSE would be required to collect from non-financial end users both initial and variation margin at such times and in such forms and such amounts, if any, that the relevant Prudential Regulator CSE might determine appropriately addressed the credit risk posed by the relevant non-financial end user and its uncleared swaps.[120] However, because of recently adopted legislation, which provides that margin requirements will not apply to many non-financial end users,[121] it seems unlikely that this requirement will become part of the Prudential Regulators' final margin regulations.

The CFTC Proposal, unlike the Prudential Regulators Proposal, would require a CFTC CSE, for transactions with nonfinancial entities with material swaps exposure to such CFTC CSE, each day to calculate both initial and variation margin amounts, as if the non-financial end user were a CSE. As a risk

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[113] BCBS/IOSCO Framework at 16-17; EU Margin RTS at 32-34.
[114] CFTC Proposal at 59913.
[115] SIFMA letter at 15.
[116] SIFMA Letter at 16.
[117] BCBS/IOSCO Framework at 6.
[118] See SR letter 13–24 "Managing Foreign Exchange Settlement Risks for Physically Settled Transactions" (December 23, 2013).
[119] See SR letter 13–24 "Managing Foreign Exchange Settlement Risks for Physically Settled Transactions" (December 23, 2013) at 1; Basel Committee on Banking Supervision, Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions, February 2013, at 16. See generally Prudential Regulators Proposal at 57352, note 27.
[120] Prudential Regulators Proposed Rules __.3(d) and __.4(c).
[121] See Business Risk Mitigation and Price Stabilization Act of 2015, Pub. L. No. 114-1, §§ 301-03, 129 Stat. __, __ (2015).

management tool, such CFTC CSE would be required to compare such hypothetical amounts to any actual margin requirements for the relevant positions.[122]

V. DOCUMENTATION REQUIREMENTS

Each of the Prudential Regulators Proposal and the CFTC Proposal would require CSEs to enter into contractual documentation with counterparties containing provisions in accordance with the respective Proposals. The CFTC and the Prudential Regulators both would require documentation with counterparties providing for contractual rights and obligations to exchange margin.[123] Both Proposals would require CSEs to enter into documentation, specifying how swaps would be valued for purposes of determining margin amounts, and how any valuation disputes would be resolved.[124] In addition, the CFTC's rule would require documentation between a CSE and a non-financial entity to state whether margin is required to be exchanged and, if so, the applicable thresholds below which margin is not required.[125]

VI. IMPLEMENTATION

A. Timing

The Proposals are aligned with each other regarding compliance dates. CFTC Chairman Timothy Massad has recently been quoted as stating that the CFTC may postpone the implementation time frame.[126]

The Proposals provide for different compliance dates for variation margin and initial margin. The compliance date for variation margin would be December 1, 2015 for all CSEs with respect to swaps with any financial end user counterparty.[127]

The timing of the Proposals' phase-in for initial margin, in contrast, would depend on the aggregate notional amount of the CSE and its affiliates, and the counterparty and its affiliates, of uncleared swaps, uncleared security-based swaps, foreign exchange forwards and foreign exchange swaps ("covered swaps").[128] Because the phase-in schedule would require market participants to aggregate their notional amounts with those of their affiliates, it appears to raise similar concerns as do the definitions of "material swaps exposure" and the initial margin threshold amount (see Parts II.A.2 and II.A.3 above). In addition, commenters have noted that because, under the proposed phase-in methodology, the timing of implementation would depend in part on the extent of a non-CSE's swap trading, the Proposals appear to give CSEs a valid reason to gather information from non-CSEs as to the extent of their swaps trading, information that non-CSEs may not wish to share.[129] Given the large number of master netting agreements that may need to be renegotiated or amended, the phase-in period, if not postponed, may not provide ample time, especially with respect to variation margin.[130]

[122] CFTC Proposed Rules 23.154(a)(6) and 23.155(a)(3); CFTC Proposal at 59907.
[123] CFTC Proposed Rule 23.158(a); Prudential Regulators Proposed Rule ___.10(a)(1).
[124] CFTC Proposed Rule 23.158(b); Prudential Regulators Proposed Rule ___.10(a)(2).
[125] CFTC Proposed Rule 23.158(a) and 23.158(b)(4) and (5).
[126] Jeremy Grant, "U.S. considers delays to OTC swap rules," The Financial Times (January 23, 2015).
[127] CFTC Proposed Rule 23.159(a)(1); Prudential Regulators Proposed Rule ___.1(d)(1).
[128] See CFTC Proposed Rule 23.159(a)(2)-(6); Prudential Regulators Proposed Rule ___.1(d)(2)-(6).
[129] See CIEBA Letter at 15.
[130] ICI Letter at 18; CIEBA Letter at 15.

The Proposals' proposed compliance dates for initial margin are as follows:

Compliance Date	Initial Margin
December 1, 2015	Initial margin where both the Covered Swap Entity combined with its affiliates and the counterparty combined with its affiliates have an average daily aggregate notional amount of covered swaps for June, July and August of 2015 that exceeds $4 trillion.
December 1, 2016	Initial margin where both the Covered Swap Entity combined with its affiliates and the counterparty combined with its affiliates have an average daily aggregate notional amount of covered swaps for June, July and August of 2016 that exceeds $3 trillion.
December 1, 2017	Initial margin where both the Covered Swap Entity combined with its affiliates and the counterparty combined with its affiliates have an average daily aggregate notional amount of covered swaps for June, July and August of 2017 that exceeds $2 trillion.
December 1, 2018	Initial margin where both the Covered Swap Entity combined with its affiliates and the counterparty combined with its affiliates have an average daily aggregate notional amount of covered swaps for June, July and August of 2018 that exceeds $1 trillion.
December 1, 2019	Initial margin for any other Covered Swap Entity with respect to covered swaps with any other counterparty.

B. Scope of Swaps Subject to the Proposals When Implemented

Under the Proposals, if a master netting agreement were to cover both swaps entered into after an applicable compliance date and swaps entered into before such compliance date, then the requirements of the Proposals with respect to both initial margin and variation margin would apply to all swaps subject to such agreement.[131] In other words, a CSE would need to enter into a new master netting agreement in order to exclude pre-compliance date swaps from the margin rules.[132]

The regulators state that, because of the possibility of excluding pre-compliance date swaps from margin calculations, margin requirements would not be applied retroactively and the unfair and disruptive effects of retroactive application of the margin rules would be avoided.[133] However, market participants, in arguing that the margin rules should not apply to pre-compliance date swaps, have noted that creating an incentive for parties to divide their swap portfolios serves no apparent purpose and indeed could increase systemic risk.[134]

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[131] CFTC Proposed Rules 23.153(c) and 23.154(b)(2); Prudential Regulators Proposed Rules ___.4(d) and ___.8(b)(2).
[132] Prudential Regulators Proposal at 57370.
[133] See CFTC Proposal at 59902; Prudential Regulators Proposal at 57370.
[134] SIFMA Letter at 21.

VII. CONCLUSION

Whatever one might think of the Proposals, surely they indicate the daunting complexity that regulators face in imposing margin requirements on uncleared swaps, to say nothing of the challenges of inter-jurisdictional harmonization. Looking at the big picture, absent major and unexpected changes, the Proposals, when finalized, will go a long way toward further de-risking one of the major markets blamed (rightly or wrongly) for exacerbating the financial crisis. One hopes that the U.S. regulators will determine that they can responsibly discharge their duties without imposing on U.S. market participants margin requirements exceeding those imposed by regulators in other jurisdictions—whether by means of the U.S. regulators' definition of "material swaps exposure," their unusually low bar for affiliation, or otherwise. Such deviations from the BCBS/IOSCO Framework would likely disadvantage U.S. market participants and further balkanize swaps trading activity.

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