

**MEMO# 28427**

October 2, 2014

## **CFTC Re-Proposes Margin Requirements for Uncleared Swaps**

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TO: SECURITIES OPERATIONS ADVISORY GROUP RE: CFTC RE-PROPOSES MARGIN REQUIREMENTS FOR UNCLEARED SWAPS

Recently, the Commodity Futures Trading Commission (“CFTC”) re-proposed margin requirements for swap dealers (“SDs”) and major swap participants (“MSPs”) that are not regulated by a prudential regulator (a covered swap entity or “CSE”). [\[1\]](#) The CFTC also is issuing an Advanced Notice of Proposed Rulemaking requesting public comment on the cross-border application of the margin requirements. The Reproposal generally is consistent with the final policy framework issued by the Basel Committee on Banking Supervision (“BCBS”) and the Board of the International Organization of Securities Commissions (“IOSCO”) establishing minimum standards for margin requirements for non-centrally cleared derivatives with certain exceptions as described below. [\[2\]](#) The Reproposal also is largely consistent with the margin proposal recently issued by the prudential regulators. [\[3\]](#) Comments on the Reproposal are due 60 days after publication of the Reproposal in the Federal Register.

### **Products Covered**

The Reproposal would cover uncleared swaps that are executed after the applicable compliance date. The definition of cleared swaps would include certain swaps that have been accepted for clearing by an entity that has received a no-action letter from the CFTC staff or exemptive relief from the Commission permitting it to clear such swaps for US persons without being registered as a derivatives clearing organization (“DCO”). In addition, physically settled foreign exchange (“FX”) swaps and FX forwards, and the fixed, physically settled FX transactions associated with the exchange of principal in cross-currency swaps would not be subject to the margin requirements.

### **Categories of Counterparties**

According to the CFTC, because different types of counterparties can pose varying levels of risk, the nature of an SD/MSP’s obligations would differ under the Reproposal depending on the type of counterparty. The Reproposal would establish three categories of

counterparties: (1) SDs and MSPs; (2) financial end users; and (3) non-financial end users. [\[4\]](#)

Financial end user would include any entity that (1) is specified in the definition and (2) is not an SD or MSP. The definition lists entities whose business is financial in nature. The CFTC's proposed definition of financial end user is the same as the Prudential Regulators' Reproposal and would include, among other things, an investment adviser, a registered investment company, a broker-dealer, a private fund, a commodity pool, a commodity pool operator, and a commodity trading advisor. For foreign entities, the CSE would be required to determine whether a foreign counterparty would fall within another prong of the financial end user definition if the foreign entity was organized under the laws of the United States or any state. The Reproposal also would permit the CFTC to designate additional entities as financial end users if it identified additional entities whose activities and risk profile would warrant inclusion.

A CSE would be required to exchange initial margin with a financial end user that has "material swaps exposure." As in the Prudential Regulators' Reproposal, the CFTC would define "material swaps exposure" for an entity to mean that the entity and its affiliates have an average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, FX forwards and FX swaps with all counterparties for June, July, and August of the previous year that exceeds \$3 billion. This aspect of the Reproposal differs from the BCBS/IOSCO Final Margin Policy Framework, which would not impose initial margin requirements on entities with less than €8 billion (approximately \$11 billion) of gross notional amount outstanding.

Non-financial end users would include any entity that is not an SD, an MSP, or a financial end user. The Reproposal would not require CSEs to exchange margin with non-financial end users.

## **Two-way Margining Requirement**

Consistent with the BCBS/IOSCO Final Margin Policy Framework and as advocated by ICI and ICI Global, the Reproposal would require CSEs to exchange margin with their covered counterparties. [\[5\]](#) Specifically, the Reproposal would require CSEs to collect initial margin from, and post initial margin with, financial end users with material swaps exposures on a daily basis. The proposed rule also would require each CSE to collect variation margin from, and to pay variation margin to, each counterparty that is a swap entity or a financial end user on or before the end of the business day after execution for each swap with that counterparty. The Reproposal would permit netting of variation margin across swaps, but the netting would have to be done pursuant to an eligible master netting agreement ("EMNA").

## **Initial Margin**

Under the Reproposal, a CSE could calculate initial margin using either a model-based method or a standardized table-based method. The required amount of initial margin would be the amount computed pursuant to the model or the table minus a threshold amount of \$65 million.

### **Model-Based Method**

The Reproposal would require CSEs to obtain the written approval of the CFTC before using

a model to calculate initial margin and to implement certain control mechanisms. The Reproposal requires the initial margin model to calculate potential future exposure using a one-tailed 99 percent confidence interval for an increase in the value of the uncleared swap or netting set of uncleared swaps due to an instantaneous price shock that is equivalent to a movement in all material underlying risk factors, including price, rates, and spreads, over a holding period equal to the shorter of ten business days or the maturity of the swap. [6] The Reproposal also would permit the use of an internal initial margin model that reflects offsetting exposures, diversification, and other hedging benefits for uncleared swaps that are governed by the same EMNA by incorporating empirical correlations within the broad risk categories, provided the CSE validates and demonstrates the reasonableness of its process for modeling and measuring hedging benefits.

The CFTC acknowledges that the resources that would be needed to review initially and assess periodically margin models would present a significant challenge for the CFTC and thus is seeking to coordinate with both domestic and foreign authorities in the review of models.

### **Table-Based Method**

Under the Reproposal, a CSE would be permitted to calculate its initial margin requirements using a standardized table, which specifies the minimum initial margin amounts that must be collected as a percentage of a swap's notional amount. The percentage would vary depending on the asset class of the swap. Consistent with the Prudential Regulators' Proposal, the CFTC permits adjustments for offsetting exposure, diversification, and other hedging to the table-based initial margin requirements. The Reproposal, therefore, would allow a CSE to calculate a net-to-gross ratio adjustment. [7] The CFTC notes that the calculation of the net-to-gross ratio for margin purposes must be applied only to swaps subject to the same EMNA and that the calculation is performed across transactions in disparate asset classes within a single netting agreement.

### **Variation Margin**

Under the Reproposal, each CSE would be required to calculate variation margin for itself and for each covered counterparty using a methodology and inputs that, to the maximum extent practicable and in accordance with existing Regulation 23.504(b)(4), rely on recently-executed transactions, valuations provided by independent third parties, or other objective criteria. Each CSE would have to have in place alternative methods for determining the value of an uncleared swap in the event of the unavailability or other failure of any input required to value a swap. The Reproposal also sets forth several control mechanisms with which each CSE would need to comply.

### **Forms of Margin**

For variation margin, consistent with the Prudential Regulators' Reproposal, the Reproposal would require that payments be made in US dollars or a currency in which payment obligations under the swap are required to be settled. [8]

The Reproposal only would allow CSEs to post or accept certain assets to meet initial margin requirements, which are consistent with the assets permitted by Prudential Regulators' Reproposal. These include: U.S. dollars; cash in a currency in which payment obligations under the swap are required to be settled; U.S. Treasury securities; certain securities guaranteed by the United States; certain securities issued or guaranteed by the

European Central bank, a sovereign entity, or the BIS; certain corporate debt securities; certain equity securities contained in major indices; major currencies; and gold. Under the proposal, certain assets would be prohibited from being used as initial margin, including any asset that is an obligation of the party providing such asset or an affiliate of that party and instruments issued by bank holding companies, depository institutions and market intermediaries. The CFTC requests comment on whether securities issued by other entities, such as non-bank systemically important financial institutions designated by the Financial Stability Oversight Council, also should be excluded from the list of eligible collateral.

Except for U.S. dollars and the currency in which the payment obligations of the swap is required, assets posted as required initial margin would be subject to haircuts to address the possibility that the value of the collateral could decline during the period that it took to liquidate a swap position in default.

## **Custodial Arrangements**

Each CSE that posts initial margin with respect to an uncleared swap must require that all funds or other property that it provided as initial margin be held by one or more custodians that were not affiliates of the CSE or the counterparty. Each CSE that collects initial margin with respect to an uncleared swap would be required to have such initial margin held at one or more custodians that are not affiliates of the CSE or the counterparty. Each CSE also would be required to enter into custodial arrangements that would prohibit rehypothecation of the margin assets and impose standards for the substitution of assets.

## **Documentation**

The Reproposal sets forth requirements for CSEs to execute documentation with each counterparty. The documentation must include, among other things, the methodology and data sources to be used to value positions and to calculate initial and variation margin, dispute resolution procedures, and any margin thresholds.

## **Compliance Dates**

The compliance dates under the Reproposal are consistent with the BCBS/IOSCO Final Margin Policy Framework. The proposed rule would be effective with respect to any swap to which a covered swap entity becomes a party on or after the relevant compliance date. For variation margin, the compliance date is December 1, 2015 for all covered swap entities with any counterparty. For initial margin, the compliance dates range from December 1, 2015 to December 1, 2019 depending on the average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, FX forwards, and FX swaps of the covered swap entity and its counterparty for June, July, and August of that year.

## **Cross-Border Transactions**

The CFTC issued an advanced notice of proposed rulemaking on the cross-border application of the proposed margin rules. The CFTC is considering three approaches to applying the margin requirements: (1) a transaction-level approach that is consistent with the CFTC's cross-border guidance ("Guidance Approach"); (2) the approach taken in the Prudential Regulators' Reproposal; and (3) an entity-level approach ("Entity-Level Approach").

With respect to the Guidance Approach, the proposed margin requirements would apply to an US SD/MSP (other than a foreign branch of a US bank that is an SD/MSP) for all of their uncleared swaps irrespective of whether the counterparty is a US person without substituted compliance. For a non-US SD/MSP, the proposed margin requirements would apply only with a US person counterparty (including a foreign branch of US bank that is an SD/MSP) and a non-US counterparty that is guaranteed by a US person or an affiliate conduit. For trades between a non-US SD/MSP and a non-US counterparty that is not a guaranteed affiliate or affiliate conduit, the Commission would not apply the margin requirements to such swaps. In the case of a foreign branch of a US bank that is an SD/MSP, the proposed margin requirements would apply with respect to all of its uncleared swaps regardless of the counterparty. Where the counterparty to the trade is another foreign branch of a US bank that is an SD/MSP or is a non-US person counterparty, the Commission would allow substituted compliance.

Under the Prudential Regulators' approach, the margin requirements would not apply to trades between a non-US SD/MSP that is not guaranteed by a US person and either a non-US SD/MSP that is not guaranteed by a US person or a non-US person that is not guaranteed by a US person. Under this approach, a non-US SD/MSP controlled by a US person would not be a foreign covered swap entity and would not qualify for the exclusion from the margin requirement. [\[9\]](#)

Finally, under the Entity-Level Approach, the margin requirements would apply on a firm-wide level, irrespective of whether the counterparty is a US person. The CFTC is considering whether to allow SDs/MSPs to satisfy the margin requirements by complying with a comparable regime in the relevant foreign jurisdiction under certain circumstances. The Reproposal sets forth a table describing situations in which substituted compliance may be available. The table is reprinted below.

## Entity-Level Approach

Counterparty A Counterparty B  
Applicable Requirements

1. U.S. SD/MSP U.S. person U.S. (All) 2. U.S. SD/MSP Non U.S. person guaranteed by a U.S. person U.S. (All) 3. Non-U.S. SD/MSP guaranteed by a U.S. person U.S. person not registered as an SD/MSP U.S. (All) 4. Non-U.S. SD/MSP guaranteed by a U.S. person Non-U.S. person guaranteed by a U.S. person U.S. (All) 5. U.S. SD/MSP Non-U.S. person not guaranteed by a U.S. person U.S. (Initial Margin collected by U.S. SD/MSP)

Substituted Compliance(Initial Margin collected by non-U.S. person not guaranteed by a U.S. person)

U.S. (Variation Margin) 6. Non-U.S. SD/MSP guaranteed by a U.S. person Non-U.S. person not guaranteed by a U.S. person U.S. (Initial Margin collected by non-U.S. SD/MSP guaranteed by a U.S. person)

Substituted Compliance(Initial Margin collected by non-U.S. person not guaranteed by a U.S. person)

U.S. (Variation Margin) 7. Non-U.S. SD/MSP not guaranteed by a U.S. person U.S. person not registered as an SD/MSP Substituted Compliance (All) 8. Non-U.S. SD/MSP not guaranteed by a U.S. person Non-U.S. person guaranteed by a U.S. person Substituted Compliance (All) 9. Non-U.S. SD/MSP not guaranteed by a U.S. person Non-U.S. SD/MSP not guaranteed by a U.S. person Substituted Compliance (All) 10. Non-U.S. SD/MSP not guaranteed by a U.S. person Non-U.S. person not registered as an SD/MSP and not guaranteed by a U.S. person Substituted Compliance (All)

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#### **endnotes**

[1] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, (Sept. 23, 2014), available at <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister092314a.pdf> ("Reproposal"). See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 77 FR 41109 (July 12, 2012), available at <http://www.gpo.gov/fdsys/pkg/FR-2012-07-12/pdf/2012-16983.pdf> (comment period reopened in light of efforts by the Basel Committee on Banking Supervision and the International Organization of Securities Commissions to develop harmonized international margin standards for uncleared swaps); Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 FR 23732 (Apr. 28, 2011), available at <http://www.gpo.gov/fdsys/pkg/FR-2011-04-28/pdf/2011-9598.pdf> ("Original Proposal").

[2] Margin Requirements for Non-Centrally-Cleared Derivatives, Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions, September 2013, available at <http://www.iosco.org/library/pubdocs/pdf/IOSCPD423.pdf> ("BCBS/IOSCO Final Margin Policy Framework").

[3] Margin and Capital Requirements for Covered Swap Entities, 79 FR 57348 (Sept. 24, 2014), available at <http://www.gpo.gov/fdsys/pkg/FR-2014-09-24/pdf/2014-22001.pdf> ("Prudential Regulators' Reproposal"). For a summary of the Prudential Regulators' Proposal, see ICI Memorandum No. 28371 (Sept. 11, 2014), available at [http://www.ici.org/my\\_ici/memorandum/memo28371](http://www.ici.org/my_ici/memorandum/memo28371).

[4] The Prudential Regulators' Reproposal distinguishes among four types of swap

counterparties: (1) counterparties that are themselves swap entities; (2) counterparties that are financial end users with a material swaps exposure; (3) counterparties that are financial end users without a material swaps exposure; and (4) other counterparties. The obligations of an SD/MSP, however, are substantially similar under both proposals.

[5] A “covered counterparty” means a financial entity with material swaps exposure, an SD, or an MSP that enters into a swap with a CSE.

[6] With respect to swaps that are executed pursuant to an EMNA between a CSE and a covered counterparty, the CSE would be permitted to calculate initial margin on an aggregate basis with respect to all uncleared swaps governed by such agreement. If the agreement covered uncleared swaps entered into before the applicable compliance date, those swaps would have to be included in the calculation.

[7] The net-to-gross ratio compares the net replacement cost of the uncleared portfolio (in the numerator) with the gross current replacement cost of the uncleared portfolio (in the denominator).

[8] This aspect of the Reproposal is stricter than the BCBS Final Margin Policy Framework, which does not require that variation margin be in cash.

[9] The Prudential Regulators’ Reproposal incorporate a “control” test for purposes of determining whether a registered SD/MSP is not a foreign entity. See Prudential Regulators’ Reproposal, *supra* note 3.