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U.S. Prudential Regulators Publish Joint Final Margin and Capital Requirements for Uncleared Swaps

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TO: DERIVATIVES MARKETS ADVISORY COMMITTEE No. 79-15
ICI GLOBAL TRADING & MARKETS COMMITTEE No. 55-15
REGISTERED FUND CPO ADVISORY COMMITTEE
SECURITIES OPERATIONS ADVISORY COMMITTEE RE: U.S. PRUDENTIAL REGULATORS PUBLISH JOINT FINAL MARGIN AND CAPITAL REQUIREMENTS FOR UNCLEARED SWAPS

The Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve, Office of the Comptroller of the Currency, Farm Credit Administration and Federal Housing Finance Agency ("Agencies") recently published joint final rules that establish margin and capital requirements for non-cleared swaps of swap dealers and major swap participants registered with the Commodity Futures Trading Commission ("CFTC") and security-based swap dealers and major security-based swap participants registered with the Securities and Exchange Commission ("SEC") (collectively, "swap entities") for which one of the Agencies is the prudential regulator ("Covered Swap Entities"). [1] The requirements apply to all of a Covered Swap Entity's swap and security-based swap activities regardless of whether the entity has registered as a swap entity, a security-based swap entity or both.

Certain transactions of specified counterparties are exempt from the margin requirements set out in the rules by the Terrorism Risk Insurance Program Reauthorization Act of 2015 ("TRIPRA"). These exemptions are discussed further in an accompanying release providing relief from the margin requirements to certain types of non-financial entities and cooperative entities that qualify for an exception or exemption from the clearing requirements. [2]

Overview

The Agencies adopted a risk-based approach for initial and variation margin requirements for Covered Swap Entities. The final rules consider the risk posed by a Covered Swap Entity's counterparties by establishing the minimum amount of initial and variation margin that the Covered Swap Entity must exchange with counterparties. The rules distinguish among four types of swap counterparties:

i. counterparties that are swap entities;
ii. counterparties that are “financial end users” [3] with “material swaps exposure;”
iii. counterparties that are financial end users without material swaps exposure; and
iv. other counterparties.

An entity has “material swaps exposure” if the entity and its affiliates [4] have an average daily aggregate notional amount of non-cleared swaps, non-cleared security-based swaps, foreign exchange forwards and foreign exchange swaps with all counterparties for business days in June, July and August of the previous calendar year that exceeds $8 billion. [5] In response to comments by the ICI and other commenters, the Agencies raised the threshold from $3 billion to $8 billion to make it consistent with international standards.

Entities that are neither swap entities nor financial end users are treated as “other counterparties,” including “commercial end users” (i.e., non-financial counterparties that are neither a swap entity nor a financial end user and engage in swaps to hedge commercial risk) and sovereigns.

Collecting and Posting Initial Margin

A Covered Swap Entity would calculate its minimum initial margin requirement in one of two ways: (a) based on a standardized margin schedule (see Appendices A and C) that allows for netting and offsetting of exposures; or (b) based on an internal margin model that satisfies certain specified conditions (see Appendix B).

Initial Margin Threshold Amount

The rules do not require a Covered Swap Entity to collect or post initial margin if the aggregate un-margined exposure either to or from its counterparty remains below $50 million, which is lower than the $65 million threshold set forth in the proposed rules. The reduced amount is attributable to significant changes in the euro-U.S. dollar exchange rates on which the initial $65 million threshold was based. The $50 million initial margin threshold is applied on a consolidated entity level across all non-exempted, non-cleared swaps between a Covered Swap Entity and its affiliates and the counterparty and the counterparty’s affiliates to preclude swap entities from creating legal entities to evade margin requirements. Moreover, this $50 million initial margin threshold is a minimum requirement and does not prevent parties from contracting with each other to exchange margin when exposures to one another are less than $50 million. In determining the initial margin collection amount and threshold, the Agencies specifically noted that separate sleeves within a fund (e.g., sleeves managed by different sub-advisers) that are generally managed under documentation that limits the asset manager’s ability to incur liability for those portions cannot be treated separately, as all the swaps of the fund are transacted on behalf of a single legal principal.

Transactions with Swap Entities

When a Covered Swap Entity engages in a non-cleared swap with another swap entity, it must collect an amount of initial margin at least as large as the initial margin collection amount less any permitted initial margin threshold amount. Likewise, the Covered Swap Entity must post at least the minimum amount of initial margin under margin rules that are applicable to that swap entity. [6]

Transactions with Financial End Users with Material Swaps Exposure

When a Covered Swap Entity engages in a non-cleared swap with a financial end user with material swaps exposure, it must collect an amount of initial margin at least as large as the initial margin collection amount less any permitted initial margin threshold amount. The Covered Swap Entity must post at least as much initial margin to the financial end user with material swaps exposure as the Covered Swap Entity would be required to collect if it were in the place of the financial end user with material swaps exposure.

Transactions with Financial End Users without Material Swaps Exposure and Other Counterparties

Covered Swap Entities transacting with a financial end user without material swaps exposure or an “other counterparty” are not subject to the initial margin requirements, and only are required to collect initial margin at such times and in such forms and amounts (if any) that the Covered Swap Entity determines appropriately address the credit risk posed by the counterparty and the risk of such swaps. The final rules would not require Covered Swap Entities transacting with these parties to post initial margin even if the Covered Swap Entity determines to request margin from either a financial end user without material swaps exposure or an “other counterparty." Therefore, there may not be bilateral margining for these types of transactions.

All Transactions

Covered Swap Entities must comply with the initial margin requirements beginning on or before the business day following the execution of the swap and ending on the date the non-cleared swap is terminated or expires. [7] Covered Swap Entities must collect and post initial margin each business day based on the initial margin amount calculated for that portfolio by the Covered Swap Entity on the previous business day. [8]

Collecting and Posting Variation Margin

The final rules require a Covered Swap Entity to collect or post variation margin for swaps with a swap entity or a financial end user (regardless of whether the financial end user has a material swaps exposure or not) at least daily in an amount that is at least equal to the increase or decrease (as applicable) in the value of such swaps since the previous exchange of variation margin. [9]& The amount of variation margin to be collected or posted (as appropriate) equals 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 posted with respect to such non-cleared swap or non-cleared security-based swap. The final rules clarify that the change in values typically would be based on mid-market prices if agreed to by the parties as requested by ICI. The Covered Swap Entity must collect this amount if the amount is positive and post this amount if the amount is negative.

The rules require variation margin to be posted or collected on a transaction date plus one or “T+1” timeframe and requires variation margin to be posted or collected no less than once daily beginning on the business day following the day of execution.

Minimum Transfer Amounts

No transactions are required unless and until the combined amount of initial and variation margin that must be collected or posted but not yet exchanged exceeds $500,000. [10] The Agencies believe that this minimum transfer amount will alleviate the operational burdens associated with making de minimis margin transfers and that the amount applies to both initial and variation margin on a combined basis.

Netting Arrangements

A Covered Swap Entity is permitted to calculate initial margin or variation margin on an aggregate net basis across non-cleared swap transactions with a counterparty that are executed under an Eligible Master Netting Agreement ("EMNA"). [11] The internal model approach for computing initial margin, however, only permits portfolio offsets for swaps within the same asset class (i.e., commodities, credit, equity or foreign exchange/interest rate) that are governed under the same asset class. [12] The final rules permit parties to document two separate netting sets, one for non-cleared swaps that are subject to the final rules and one for swaps that are not subject to the margin requirements. A netting portfolio that contains only non-cleared swaps entered into before the applicable compliance date is not subject to the requirements of the rules. Any netting portfolio that contains any non-cleared swap entered into after the applicable compliance date, however, will subject the entire netting portfolio to the requirements of the rules. Thus, the separate netting portfolios allow a Covered Swap Entity to avoid subjecting its pre-compliance date swaps to the margin requirements, while still maintaining both its pre- and post-compliance date swaps under a single EMNA. Similarly, separate netting portfolios can be established for swaps entered into before and after a financial end user's change into a higher risk status, thus the pre-status change swaps would not be subject to the stricter margin requirements.

Eligible Collateral

The final rules limit the types of collateral that are eligible to be used for initial and variation margin. Eligible collateral for initial margin includes cash (denominated in any "major currency" [13] or the currency of settlement [14]), debt securities that are issued or guaranteed by the U.S. or another agency, the Bank for International Settlements, the International Monetary Fund, the European Central Bank, multilateral development banks, certain debt securities of government sponsored enterprises, certain foreign government debt securities, certain corporate debt securities, certain listed equities, shares in pooled investment vehicles, [15] and gold.

Eligible collateral for variation margin depends on the counterparty the Covered Swap Entity is facing. For swaps between a Covered Swap Entity and another swap entity, eligible collateral is limited to only immediately available cash funds denominated in U.S. dollars, another major currency or the currency of settlement. When a Covered Swap Entity faces financial end users, as requested by ICI and other commenters, the final rules now permit a Covered Swap Entity to exchange variation margin using any of the collateral permitted for initial margin collateral rather than only in cash as proposed.

To avoid "wrong-way" risk, the rules exclude securities issued by a bank holding company, a savings and loan holding company, a foreign bank, a depository institution, a market intermediary, or any company that would be one of the foregoing if it is organized under the U.S. or a state, or an affiliate of one of the foregoing. The rules do not allow a Covered Swap Entity to fulfill the minimum margin requirements with assets that are not on the eligible collateral list.

Non-cash collateral is subject to a "haircut" or discount as determined using Appendix D. In addition, the rules impose an eight percent cross-currency haircut on eligible collateral denominated in a currency other than the currency of settlement, except that variation margin in immediately available cash funds in any major currency would not subject to a haircut. [16] If the value of collateral decreases or the quality of the collateral has deteriorated so that it no longer qualifies as eligible collateral, the Covered Swap Entity must collect or post additional collateral of sufficient value and quality to ensure that all minimum margin requirements are satisfied daily.

The rules also permits Covered Swap Entities to collect or post initial or variation margin that is not required pursuant to the rule in any form of collateral.

Collateral Segregation

Any initial margin that a Covered Swap Entity collects (up to the amount required by the rules) from a swap entity or a financial end user with material swaps exposure must be held at one or more custodians that are not affiliated with either the Covered Swap Entity, the counterparty or their affiliates (each, a "third-party custodian"). Therefore, under the final rules, a registered fund would not be able to engage in a non-cleared swap transaction with an affiliate of its independent custodian if it has to post margin under the final rules.

In addition, collateral posted by a Covered Swap Entity (even in excess of any required by the final rules), other than variation margin, must be kept at one or more third-party custodians. The custodial agreement must prohibit the custodian from transferring the initial margin or other property, except that any cash collateral may be held in a general deposit account with the custodian if the funds in the account are used to purchase other forms of eligible collateral. Notwithstanding the prohibition on transferring, a posting party may substitute or direct any reinvestment of collateral if the posting party substitutes only funds or other property that are eligible collateral and the amount net of applicable discounts continues to be sufficient to meet the initial margin requirements.

Except for collateral posted by a Covered Swap Entity, any funds or property held by a third-party custodian in excess of the amounts required to be collected or posted are not subject to the restrictions on substitution or reinvestment or held by an independent custodian. [17] The final rules do not require any variation margin collected or posted to be held by a third-party custodian or subject such collateral to restrictions on transferring.

In addition, because cash funds generally are treated as a general deposit by a bank in exchange for a contractual debt obligation and such obligations raise heightened risks, the Agencies have permitted cash funds that are placed with a custodian bank in return for a general deposit obligation to serve as initial margin collateral only in specified circumstances. Specifically, the rule requires the posting party to direct the custodian to re-invest the deposited funds into eligible non-cash collateral of some type, or the posting party must deliver non-cash collateral to substitute for the deposited funds (with appropriate haircuts).

Cross-Border Transactions and Substituted Compliance

Foreign non-cleared swaps and foreign non-cleared security-based swaps [18] of Foreign Covered Swap Entities [19] are excluded from the margin requirements. To be excluded from the rules, no U.S. entity may guarantee either party's obligation under the swap.

In addition, certain Covered Swap Entities that are operating in a foreign jurisdiction (i.e., Foreign Covered Swap Entities, and foreign subsidiaries of U.S. depository institutions or

Edge or agreement corporations) and Covered Swap Entities that are U.S. branches or agencies of foreign banks may abide by the swap margin requirements of the foreign jurisdictions if the Agencies determine that the foreign regulator's swap margin requirements are comparable to the final rules, provided that the Covered Swap Entity's obligations under the swap are not guaranteed by a U.S. entity (other than a U.S. branch, agency or subsidiary of foreign bank) or by a natural person who is a U.S. resident. If a foreign counterparty is subject to a foreign regulatory framework that has been determined to be comparable by the Agencies, Covered Swap Entities also would be allowed to post margin to a foreign counterparty pursuant to a foreign regulator's swap margin requirements, provided that the foreign counterparty does not have a guarantee from an entity organized under the laws of the United States or any state (though it must collect the amount of margin as required under the U.S. rules).

The Agencies jointly will make a determination regarding the comparability of a foreign regulatory framework that will focus on the outcomes produced by the foreign framework as compared to the U.S. framework. In so doing, the Agencies would take a holistic view of the foreign regulatory framework that appropriately considers the outcomes produced by the entire framework.

Documentation of Margin Matters

Under the rules, a Covered Swap Entity must execute trading documentation with each counterparty that is a swap entity or a financial end user regarding credit support arrangements. The documentation must provide the Covered Swap entity the contractual rights and obligations to collect and post initial and variation margin in such amounts, and in such forms, and under such circumstances as required by the final rules. The documentation also must specify the methods, procedures, rules, and inputs for determining the value of each non-cleared swap for purposes of calculating variation margin and the procedures by which any disputes concerning the valuation of non-cleared swaps or the valuation of assets collected or posted as initial margin or variation margin may be resolved. Finally, the documentation also must describe the methods, procedures, rules and inputs used to calculate initial margin for non-cleared swaps entered into between the Covered Swap Entity and the counterparty.

Compliance Dates

The margin requirements apply to non-cleared swaps entered into on or after the applicable compliance dates, which include swaps entered into prior to the compliance date but that are amended, or novated or create new derivatives from portfolio compression of legacy derivatives. Once a Covered Swap Entity and its counterparty must comply with the margin requirements for non-cleared swaps, the Covered Swap Entity and its counterparty will remain subject to the margin requirements from that point forward unless there is a change in the status of the counterparty. If a Covered Swap Entity's counterparty becomes subject to stricter margin requirements, then the Covered Swap Entity shall comply with the stricter margin requirements for any non-cleared swap or security-based swap entered into with the counterparty after the status change. If a Covered Swap Entity's counterparty becomes subject to less strict margin requirements, then the Covered Swap Entity may comply with the less strict margin requirements for any swap or security-based swap entered into with that counterparty after the status change, as well as for any non-cleared swap or security-based swap entered into after the compliance date and before the status change.

Initial Margin

For purposes of initial margin, the compliance dates range from September 1, 2016 to September 1, 2020 depending on the average daily aggregate notional amount of non-cleared swaps, non-cleared security-based swaps, foreign exchange forwards and swaps (collectively, covered swaps) of the Covered Swap Entity and its counterparty (accounting for their respective affiliates):

Compliance Date

Initial Margin Requirements in which both the Covered Swap Entity and counterparty (including their affiliates) have an average daily aggregate notional amount of covered swaps for March, April and May of the compliance date year that exceeds:

September 1, 2016

$3 trillion

September 1, 2017

$2.25 trillion

September 1, 2018

$1.5 trillion

September 1, 2019

$0.75 trillion

September 1, 2020

Initial margin for any other Covered Swap Entity with respect to covered swaps with any other counterparty

Variation Margin

For purposes of variation margin, the compliance dates are September 1, 2016 and March 1, 2017. These compliance dates depend on the average daily aggregate notional amount of covered swaps of the Covered Swap Entity combined with its affiliates and each of its counterparties (combined with that counterparty's affiliates) for each business day in March, April and May of that year.

Compliance Date

Variation Margin Requirements in which both the Covered Swap Entity and each its counterparty (including their affiliates) have an average daily aggregate notional amount of covered swaps for March, April and May of the compliance date year that exceeds:

September 1, 2016

$3 trillion

September 1, 2017

Variation margin for any other Covered Swap Entity with respect to covered swaps with any other counterparty.

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Appendix A: Requirements for Using the Standardized Initial Margin Approach

Under the rules, Covered Swap Entities may elect to use standardized initial margins, which are computed as follows:

- The Net-to-Gross Ratio and gross standardized initial margin amounts (provided in Appendix C) are used in conjunction with the notional amount of the transactions in the underlying swap portfolio to arrive at the total initial margin requirement as follows:
    - Standardized Initial Margin = 0.4 x Gross Initial Margin + 0.6 x Net-to-Gross Ratio x Gross Initial Margin where:
        - Gross Initial Margin is the sum of the notional value of each swap multiplied by the appropriate initial margin requirement percentage from Appendix C of each non-cleared swap under the EMNA; and
        - The Net-to-Gross Ratio compares the net current replacement cost of the non-cleared portfolio (in the numerator) with the gross current replacement cost of the non-cleared portfolio (in the denominator). [20]
            - The net current replacement cost is the cost of replacing the entire portfolio of swaps that are covered under the EMNA.
            - The gross current replacement cost is the cost of replacing those swaps that have a strictly positive replacement cost under the EMNA.
            - As an example, consider a portfolio that consists of two non-cleared swaps under an EMNA in which the mark-to-market value of the first swap is $10 (i.e., the covered swap entity is owed $10 from its counterparty) and the mark-to-market value of the second swap is -$5 (i.e., the covered swap entity owes $5 to its counterparty). The net current replacement cost is $5 ($10-$5), the gross current replacement cost is $10, and the Net-to-Gross Ratio

would be 5/10 or 0.5.

        - Suppose further that the swap with the mark-to-market value of $10 is a sold 5-year credit default swap with a notional value of $100 and the swap with the mark-to-market value of -$5 is an equity swap with a notional value of $100. The standardized initial margin requirement would then be:
        [0.4 x (100 x 0.05 + 100 x 0.15) + 0.6 x 0.5 x (100 x 0.05 + 100 x 0.15)]=8+6=14.

    - The calculation is performed without considering any variation margin payments. This is intended to ensure that the Net-to-Gross Ratio calculation reflects the extent to which the non-cleared swaps generally offset each other and not whether the counterparties have agreed to exchange variation margin.

- Standardized initial margins depend on the asset class (commodity, equity, credit, foreign exchange and interest rate) and, in the case of credit and interest rate asset classes, further depend on the duration of the underlying non-cleared swap.
- The Agencies further note 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 EMNA such as credit and equity in the above example (i.e., all non-cleared swaps subject to the same EMNA and subject to the final rule's requirements can net against each other in the calculation of the Net-to-Gross Ratio, as opposed to the modeling approach that allows netting only within each asset class).
- If a counterparty maintains multiple non-cleared swap portfolios under one or multiple EMNAs, the standardized initial margin amounts would be calculated separately for each portfolio with each calculation using the gross initial margin and Net-to-Gross Ratio that is relevant to each portfolio.
- The total standardized initial margin would be the sum of the standardized initial margin amounts for each portfolio.
- The standardized initial margin collection amount must be calculated on a daily basis.

Appendix B: Requirements for Using an Internal Margin Model:

The final rules permit Covered Swap Entities to utilize their own internal models to calculate initial margin requirements for non-cleared swaps, subject to the standards and criteria related to the technical aspects of the model as well as broader oversight and governance standards, including:

- The initial margin amount must equal a model's calculation of the potential future exposure of the non-cleared swap consistent with a one-tailed 99 percent confidence level over a 10-day close-out period. [21] More specifically, initial margin models must capture all of the material risks that affect the non-cleared swap, including the material non-linear price characteristics of the swap.

- The margin calculations for derivatives in distinct product-based asset classes, such as equity and credit, must be performed separately without regard to derivatives contracts in other asset classes. Each derivative contract must be assigned to a single asset class in accordance with the classifications in the final rule (i.e., foreign exchange or interest rate, commodity, credit, and equity). [22]
- The initial margin model must employ a stress period calibration for each broad asset class (commodity, credit, equity, and interest rate and foreign exchange). The stress period calibration employed for each broad asset class must be appropriate to the specific asset class in question. The time period used to inform the stress period calibration must include at least one year, but no more than five years of equally-weighted historical data.
- All initial margin models must be approved by a Covered Swap Entity's prudential regulator before being used for margin calculation purposes. If a model is not approved, initial margin calculations must be performed according to the standardized initial margin approach that is detailed in Appendix A and discussed above.
- An approved initial margin model must calculate the required initial margin collection amount on a daily basis.
- An approved initial margin model generally must account for all of the material risks that affect the non-cleared swap, except in the specific case of cross-currency swaps. In a cross-currency swap, one party exchanges with another party principal and interest rate payments in one currency for principal and interest rate payments in another currency, and the exchange of principal occurs upon the inception of the swap, with a reversal of the exchange of principal at a later date that is agreed upon at the inception of the swap. Under the rules, an initial margin model need not recognize any risks or risk factors associated with the foreign exchange transactions associated with the fixed exchange of principal embedded in a cross-currency swap. The initial margin model must recognize all risks and risk factors associated with all other payments and cash flows that occur during the life of the cross-currency swap.
- A Covered Swap Entity must periodically, and no less than annually, review its initial margin model in light of developments in financial markets and modeling technologies and make appropriate adjustments to the model.
- The data used to calibrate and execute the initial margin model also must be reviewed no less frequently than annually to ensure that the data is appropriate for the products for which initial margin is being calculated.
- The final rules also require that the model be independently validated prior to implementation and on an ongoing basis which would also include a monitoring process that includes back-tests of the model and related analyses to ensure that the level of initial margin being calculated is consistent with the underlying risk of the swap being margined.
- Initial margin models also must be subject to explicit escalation procedures that would make any significant changes to the model subject to internal review and approval before taking effect. Any such changes or extensions of the initial margin model must be communicated to the relevant Agency 60 days prior to taking effect to give the

Agency the opportunity to rescind its prior approval or subject it to additional conditions.

- Each Agency must find that any Covered Swap Entity subject to its regulation is in compliance with all aspects of that Agency's margin requirements including the standards for initial margin models.

Appendix C: Standardized Minimum Initial Margin Requirements for Non-Cleared Swaps and Non-Cleared Security-Based Swaps

Standardized Minimum Gross Initial Margin Requirements for Non-Cleared Swaps and Non-Cleared Security-Based Swaps [23]

Asset Class	Gross Initial Margin (% of Notional Exposure)
Credit: 0-2 year duration	2
Credit: 2-5 year duration	5
Credit: 5+ year duration	10
Commodity	15
Equity	15
Foreign Exchange/Currency	6
Cross Currency Swaps: 0-2 year duration	1
Cross-Currency Swaps: 2-5 year duration	2
Cross-Currency Swaps: 5+ year duration	4

Interest Rate: 0-2 year duration

1

Interest Rate: 2-5 year duration

2

Interest Rate: 5+ year duration

4

Other

15

Appendix D: Margin Values for Eligible Non-Cash Margin Collateral

Margin Values for Eligible Noncash Margin Collateral

Asset Class [24]

Discount (%)

Eligible government and related debt (e.g., central bank, multilateral development bank, GSE securities as defined in the final rules): residual maturity less than one-year

0.5

Eligible government and related debt (e.g., central bank, multilateral development bank, GSE securities as defined in the final rules): residual maturity between one and five years

2.0

Eligible government and related debt (e.g., central bank, multilateral development bank, GSE securities as defined in the final rules): residual maturity greater than five years

4.0

Eligible GSE debt securities: residual maturity less than one year

1.0

Eligible GSE debt securities: residual maturity between one and five years

4.0

Eligible GSE debt securities: residual maturity greater than five years

8.0

Other eligible publicly traded debt: residual maturity less than one-year

1.0

Other eligible publicly traded debt: residual maturity between one and five years

4.0

Other eligible publicly traded debt: residual maturity greater than five years

8.0

Equities included in S&P 500 or related index

15.0

Equities included in S&P 1500 Composite or related index but not S&P 500 or related index

25.0

Gold

15.0

endnotes

[1] See Final Rule to Margin and Capital Requirements for Covered Swap Entities, available at: https://fdic.gov/news/board/2015/2015-10-22_notice_dis_a_fr_final-rule.pdf. The joint final rules adopt rules re-proposed in Margin and Capital Requirements for Covered Swap Entities, 79 Fed. Reg. 57348 (September 24, 2014), available at http://www.gpo.gov/fdsys/pkg/FR-2014-09-24/pdf/2014-22001.pdf. For a summary of the proposed rules, see ICI Memorandum 28371 (September 11, 2014), available at https://www.ici.org/my_ici/memorandum/memo28371.

[2] Certain transactions with specified non-financial end users and other financial counterparties are exempt from the margin requirements for covered swaps if they:

> (1) qualify for an exception from clearing under Section 2(h)(7)(A) of the Commodity Exchange Act of 1936 (“CEA”) (i.e., non-financial entities using swaps to hedge or mitigate commercial risk that notify the CFTC about how they generally meet their financial obligations);
>
> (2) qualify for an exemption under Section 4(c)(1) of the CEA (permitting cooperative entities that meet certain qualifications to elect not to clear certain swaps that are otherwise required to be cleared); or
>
> (3) satisfy the criteria in Section 2(h)(7)(D) of the CEA (providing that, when a person qualifies for an exception from the clearing requirements, an affiliate of that person may qualify for the exception as well if the affiliate is acting on behalf of the person as agent and uses the swap to hedge or mitigate the commercial risk of the person or other affiliate of the person that is not a financial entity).

Certain transactions with specified non-financial end users and other financial counterparties are exempt from the margin requirements for covered security-based swaps if the counterparty:

(1) qualifies for an exception under Section 3C(g)(1) of the Securities Exchange Act of 1934 ("1934 Act") (i.e., non-financial entities using security-based swaps to hedge or mitigate commercial risk and that notify the SEC about how they generally meets their financial obligations); or

(2) satisfies the criteria in Section 3C(g)(4) of the 1934 Act (providing that, when a person qualifies for an exception from the clearing requirements, an affiliate of that person may qualify for the exception as well if the affiliate is acting on behalf of the person as agent and uses the swap to hedge or mitigate the commercial risk of the person or other affiliate of the person that is not a financial entity).

A "financial entity" means (i) a swap dealer; (ii) a security-based swap dealer; (iii) a major swap participant; (iv) a major security-based swap participant; (v) a commodity pool; (vi) a private fund; (vii) an employee benefit plan; (viii) a person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature.

In addition, the TRIPRA exemption also applies to a Covered Swap Entity's swap with a financial institution with total assets of $10 billion or less if the institution uses the swap to hedge commercial risk. See Interim Rule to Margin and Capital Requirements for Covered Swap Entities, available at: https://fdic.gov/news/board/2015/2015-10-22_notice_dis_a_fr_interim-final-rule.pdf. The interim rule is promulgated as an interim final rule with a request for public comment. The comment period for the interim rule ends on January 31, 2016.

[3] A "financial end user" is an entity that is not a swap entity and is one of several specified entities, including an SEC-registered fund, an SEC-registered investment adviser, a business development company, a private fund, a commodity pool, a commodity pool operator or commodity trading advisor, a bank or savings and loan holding company, a depository institution, a foreign bank, a federal or state credit union, a securities holding company, a broker-dealer, an employee benefit plan, an insurance company, any entity, person, or arrangement that is or holds itself out as being an entity, person or arrangement that raises money from investors, accepts money from clients or uses its own money primarily for the purpose of investing or trading or facilitating the investing or trading in assets for disposition or otherwise trading in assets, or an entity that is or would be a financial end user or swap entity if they were organized in the United States.

[4] For purposes of the rules, a company is deemed to be an "affiliate" of another company if: (a) either company consolidates the other on financial statements prepared with U.S. Generally Accepted Accounting Principles, the International Financial Reporting Standards, or other similar standards; (b) both companies are consolidated with a third company's on a financial statement prepared in accordance with such principles or standards; (c) for a company that is not subject to such principles or standards, if consolidations described in (a) or (b) would have occurred if such principles or standards had applied; or (d) an Agency has determined that a company is an affiliate of the other company based on the Agency's conclusion that either company provides significant support to, or is materially subject to the risk of losses of, the other company. This is a change from the proposed rules, which would have defined affiliate to mean any company that controls is controlled by or is under common control with another company. This presumably would result in a higher level of affiliation than the 25 percent voting interest standard.

[5] The threshold would encompass foreign exchange forwards and swaps, even if those foreign exchange forwards and swaps are exempt from the definition of swap by the U.S. Department of Treasury. In addition, the Agencies state that it would be reasonable for a Covered Swap Entity to rely in good faith on reasonable representations of its counterparty in making assessments of material swaps exposure.

[6] All swap entities will be subject to a rule on minimum margin for non-cleared swaps promulgated by one of the Agencies, the SEC or the CFTC. If a counterparty is a Covered Swap Entity, it must collect at least the amount of margin required under these final rules. If a counterparty is a swap entity subject to the margin rules of the CFTC or SEC, it must collect the amount of margin required under the CFTC or SEC margin rules.

[7] For purposes of determining the day of execution of a swap, the rules set forth three special accommodations for swaps between parties located in different time zones:

> (1) If at the time the parties enter into the swap, it is a different calendar day at the location of each party, the day of execution is the latter of the two calendar days;
>
> (2) If a non-cleared swap is entered into between 4:00 p.m. and midnight in the location of a party, then such non-cleared swap shall be deemed to have been entered into on the immediately succeeding day that is a business day for each party; and
>
> (3) If the day of execution determined under the foregoing rules is not a business day for both parties, the day of execution shall be deemed to be the immediately succeeding day that is a business day for both parties.

[8] The Agencies recognize that the final rules require initial margin to be collected and posted so quickly that Covered Swap Entities and their counterparties may be required to take steps such as pre-positioning eligible margin collateral securities at the custodian and using readily-transferrable forms of eligible cash to place additional margin quickly with the custodian from time to time, but did not change the proposed timing for initial margin collection because the Agencies believe the additional delay would reduce the overall effectiveness of the margin requirements.

[9] The Agencies generally believe that variation margin, unlike initial margin, should apply to all financial entity counterparties because the daily exchange of variation margin is an important risk mitigant that: (i) reduces the build-up of risk that may ultimately pose systemic risk; (ii) imposes a lesser liquidity burden than does initial margin; and (iii) reflects both current market practice and a risk management best practice.

[10] The minimum transfer amount only affects the timing of the margin collection and not the amount of margin that must be collected. For example, if the margin amount due from (or to) the counterparty were to increase from $500,000 to $800,000, the Covered Swap Entity would be required to collect the entire $800,000 (subject to application of any applicable initial margin threshold amount).

[11] An EMNA is any written, legally enforceable netting agreement that creates a single legal obligation for all individual transactions covered by the agreement upon an event of default under certain conditions. These conditions include a requirement with respect to the Covered Swap Entity’s right to terminate the contract and liquidate collateral, and certain

standards with respect to the legal review of the agreement to ensure it meets the criteria in the definition. The legal review must be sufficient so that the Covered Swap Entity has a well-founded basis to conclude that, among other things, the contract would be found legal, binding and enforceable under the law of the relevant jurisdiction. If a Covered Swap Entity cannot conclude after sufficient legal review on a well-founded basis that a netting agreement meets the definition of an EMNA, the final rules require the Covered Swap Entity to collect the gross margin amount required but may still apply the netting provisions of the rule in determining the amount of margin to be posted to the counterparty.

[12] See Appendix B (discussing requirements for using an internal margin model).

[13] The rules define "major currency" as the: (i) U.S. dollar; (ii) Canadian dollar; (iii) euro; (iv) U.K. pound; (v) Japanese yen; (vi) Swiss franc; (vii) New Zealand dollar; (viii) Australian dollar; (ix) Swedish kronor; (x) Danish kroner; (xi) Norwegian krone; or (xii) any other currency as defined by the relevant Agency.

[14] The "currency of settlement" means the currency in which a party has agreed to discharge payment obligations related to a non-cleared swap, a non-cleared security-based swap, a group of non-cleared swaps, or a group of non-cleared security-based swaps subject to a master agreement at the regulatory occurring dates on which such payments are due in the ordinary course.

[15] Any pooled investment vehicle, such as a money market fund, must hold only securities that are issued by, or unconditionally guaranteed as to the timely payment of principal and interest by, the U.S. Department of Treasury, and cash funds denominated in U.S. dollars or securities that are denominated in a common currency and issued by, or fully guaranteed as to the timely payment of principal and interest by, the European Central Bank or a sovereign entity that is assigned no higher than a 20 percent risk weight under applicable regulatory capital rules, and cash denominated in the same currency. These pooled investment vehicles must issue redeemable securities representing the holder's proportional interest in the fund's net assets, issued and redeemed only on the basis of the fund's net assets prepared each business day after the holder makes its investment or redemption request to the fund. In addition, the assets of the fund may not be transferred or re-hypothecated through securities lending, securities borrowing, repurchase agreements, reverse repurchase agreements, or similar arrangements.

[16] The Agencies eliminated this haircut because the cash funds are liquid at the point of counterparty default, and there are robust markets in the major currencies that allow conversion or hedging to the currency of settlement or termination at relatively low cost.

[17] In this regard, the Agencies did not address ICI's request that the excess margin posted by a counterparty to a Covered Swap Entity be required to be held at an independent custodian with all other collateral posted by a Covered Swap Entity.

[18] A "foreign non-cleared swap" or "foreign non-cleared security-based swap" covers any non-cleared swap or non-cleared security-based swap, respectively, of a Foreign Covered Swap Entity (as defined below) to which neither the counterparty nor any guarantor (on either side) is (i) an entity organized under U.S. or state law; (ii) a branch or office of an entity organized under U.S. or state law; or (iii) a swap entity that is a subsidiary of an entity organized under U.S. or state law.

[19] A "Foreign Covered Swap Entity" is any Covered Swap Entity that is not (i) an entity

organized under U.S. or state law; (ii) a branch or office of an entity organized under U.S. or state law; or (iii) a branch or office of an entity organized under U.S. or state law. Neither a foreign branch of a U.S. bank nor a foreign subsidiary of a U.S. company would be considered a Foreign Covered Swap Entity.

[20] At the time non-cleared swaps are entered into, often both the net and gross current replacement cost is zero. This precludes the calculation of the Net-to-Gross Ratio. In cases where a new swap is being added to an existing portfolio that is being executed under an existing EMNA, the Net-to-Gross Ratio may be calculated with respect to the existing portfolio of swaps. In cases where an entirely new swap portfolio is being established, the initial value of the Net-to-Gross Ratio should be set to 1.0. After the first day's mark-to-market valuation has been recorded for the portfolio, the Net-to-Gross Ratio may be re-calculated and the initial margin amount may be adjusted based on the revised Net-to-Gross Ratio.

[21] Since non-cleared swaps are expected to be less liquid than cleared swaps, the final rules specify a minimum close-out period for the initial margin model of 10 business days, compared with a typical requirement of 3 to 5 business days used by central counterparties (CCPs). A long horizon calculation (such as 10 days) may, under certain circumstances, be indirectly computed by making a calculation over a shorter horizon (such as 1 day) and then scaled to the longer 10-day horizon according to a fixed rule to be consistent with the longer 10-day horizon.

[22] The final rule permits a covered swap entity to use an internal initial margin model that reflects offsetting exposures, diversification, and other hedging benefits within four broad risk categories: commodities, credit, equity, and foreign exchange and interest rates (considered together as a single asset class) when calculating initial margin for a particular counterparty if the non-cleared swaps are executed under the same EMNA. The final rule does not permit an initial margin model to reflect offsetting exposures, diversification, or other hedging benefits across those broad risk categories. As a specific example, if a covered swap entity entered into two non-cleared credit swaps and two non-cleared commodity swaps with a single counterparty under an EMNA, the covered swap entity could use an approved initial margin model to perform two separate initial margin calculations: the initial margin collection amount calculation for the non-cleared credit swaps and the initial margin collection amount calculation for the non-cleared commodity swaps. Each calculation could recognize offsetting and diversification within the non-cleared credit swaps and within the non-cleared commodity swaps. The result of the two separate calculations would then be summed together to arrive at the total initial margin collection amount for the four non-cleared swaps (two non-cleared credit swaps and two non-cleared commodity swaps).

[23] The initial margin amount applicable to multiple non-cleared swaps or non-cleared security-based swaps subject to an eligible master netting agreement that is calculated according to this appendix will be computed as follows:

> Initial Margin = 0.4 x Gross Initial Margin + 0.6 x Net-to-Gross Ratio x Gross Initial Margin

where:

> Gross Initial Margin = the sum of the product of each non-cleared swap's or non-

cleared security-based swap’s effective notional amount and the gross initial margin requirement for all non-cleared swaps and non-cleared security-based swaps subject to the eligible master netting agreement;

and

Net-to-Gross Ratio = the ratio of the net current replacement cost to the gross current replacement cost. In calculating Net-to-Gross Ratio, the gross current replacement cost equals the sum of the replacement cost for each non-cleared swap and non-cleared security-based swap subject to the eligible master netting agreement for which the cost is positive. The net current replacement cost equals the total replacement cost for all non-cleared swaps and non-cleared security-based swaps subject to the eligible master netting agreement. In cases where the gross replacement cost is zero, the Net-to-Gross Ratio should be set to 1.0.

[24] The discount to be applied to an eligible investment fund is the weighted average discount on all assets within the eligible investment fund at the end of the prior month. The weights to be applied in the weighted average should be calculated as a fraction of the fund’s total market value that is invested in each asset with a given discount amount. As an example, an eligible investment fund that is comprised solely of $100 of 91 day Treasury bills and $100 of 3 year US Treasury bonds would receive a discount of (100/200) * 0.5 + (100/200) * 2.0 = (0.5) * 0.5 + (0.5) * 2.0 = 1.25 percent.