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CFTC Proposes to Amend Margin Requirements for Non-Cleared Swaps

[32690]

August 20, 2020 TO: ICI Members
ICI Global Members
Derivatives Markets Advisory Committee
ICI Global Trading & Markets Committee
LIBOR Transition Working Group SUBJECTS: Compliance
Derivatives
International/Global
Investment Advisers
Trading and Markets RE: CFTC Proposes to Amend Margin Requirements for Non-Cleared Swaps

On August 14, the CFTC issued two proposals to amend certain margin requirements for non-cleared swaps for swap dealers (SDs) and major swap participants (MSPs) (collectively, "covered swap entities" or CSEs). The CFTC Global Markets Advisory Committee's Subcommittee on Margin Requirements for Non-Cleared Swaps recommended these amendments in May to address challenges related to Phase 5 and Phase 6 implementation of the margin requirements.[1]

Amendments to "Material Swap Exposure"

Under the first proposal, the CFTC would amend its requirements related to the calculation of "material swaps exposure" (MSE), as defined under Regulation 23.151, to align with the Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions' framework for margin requirements for non-centrally-cleared derivatives ("BCBS/IOSCO Framework").

Under the CFTC's current initial margin requirements:

- Phase 6 entities[2] are required to start exchanging initial margin on September 1, 2021.[3]
- The calculation to determine whether a financial end-user has MSE (and therefore, would be subject to initial margin requirements) must occur on September 1, 2021, based on the average daily AANA during the period of June, July, and August of the prior year, *i.e.*, 2020.
- After the compliance date, the MSE determination must occur on January 1 of each

year based on the average daily AANA during the period of June, July and August of the prior year. If a financial end-user has MSE, then initial margin requirements would begin to apply on January 1.

The BCBS/IOSCO Framework, however, specifies an implementation date of September 1 and bases the MSE calculation on the average of month-end AANA for March, April, and May of the same year. The Commission noted that other major market jurisdictions have adopted this approach.

Therefore, the CFTC proposes to align its requirements with BCBS/IOSCO and amend the MSE definition to adopt the BCBS/IOSCO calculation period and utilize average month-end, instead of average daily, AANA. The CFTC notes that changing the calculation period would reduce the preparation time for compliance and could also affect whether a financial end-user is subject to initial margin requirements.[4] The CFTC also noted that basing the calculation on average month-end AANA could lead to a less precise determination of a financial end-user's swap exposure. Nevertheless, the CFTC stated that aligning its requirements with the international approach would provide benefits, *e.g.*, reduced compliance burdens, that outweigh those concerns.

The CFTC requests comment on the proposed alignment, including whether a "month-end" methodology would lead to a less precise calculation of swaps exposure and/or the risk of "window-dressing," *i.e.*, adjustment of exposures near a month-end date to avoid margin requirements.[5]

Codification of Relief Related to Initial Margin Calculations for Smaller CSEs

Under the first proposal, the CFTC would also amend Regulation 23.154(a), which requires CSEs to calculate initial margin to be collected, to permit a CSE that enters into an non-cleared swap with a swap entity counterparty to use the latter's risk-based model calculation of in lieu of its own calculation.[6] The CFTC states that this amendment is intended to relieve smaller CSEs from the "disproportionate" burden of maintaining their own calculation model. The amendment would effectively codify CFTC No-Action Letter No. 19-29, which provides similar relief to a specific CSE.

The ability to use a swap entity counterparty's risk-based calculation would be subject to two conditions that currently govern the no-action relief.[7] First, the risk-based model must be approved by the CFTC or the National Futures Association pursuant to Regulation 23.154(b); or approved by the swap entity's prudential regulator. Second, the non-cleared swaps into which the CSE enters (and for which initial margin is calculated) must be for the purpose of hedging the CSE's own risk.

Codification of Relief Related to Minimum Transfer Amount

Under the second proposal, the CFTC would amend certain requirements related to the "minimum transfer amount" (MTA) threshold for exchanging initial margin and variation margin. These amendments would effectively codify CFTC No-Action Letters No. 17-12 and 19-25.[8] These letters respectively provide relief from Regulations 23.152(b)(3) and 23.153(c), which establish that a CSE is not required to collect or post initial margin and variation margin until the combined amount exceeds the MTA threshold of $500,000.

First, the CFTC proposes to amend the MTA definition under Regulation 23.151, with conforming changes to Regulations 23.152(b)(3) and 23.153(c), to allow a CSE to apply an MTA of up to $50,000 to each "separately managed account" (SMA)[9] with which a CSE enters into a non-cleared swap. The CFTC stated that separate treatment of SMAs with respect to administering an MTA may be necessary from an operational perspective. For example, an SMA owner may not be able to coordinate trading activity across their SMAs to collectively calculate the MTA and corresponding asset managers may be prohibited from sharing information with one another due to confidentiality restrictions.

The CFTC requests comment on (i) whether a $50,000 MTA for each SMA would lead the creation of more SMAs, which could allow an SMA owner to exceed the $500,000 threshold without being subject to margin requirements; and (ii) whether SMA owners and their asset managers should instead be required to coordinate with one another under a single MTA.

Second, the CFTC proposes to amend the margin documentation requirements under 23.158(a), with conforming changes to Regulations 23.152(b)(3) and 23.153(c), to allow a CSE to apply separate MTAs for initial margin and variation margin with each counterparty. To apply separate MTAs, these MTA amounts must be specified in the required margin documentation, and on a combined basis, must not exceed the specified MTA limit.[10] The CFTC stated that allowing separate MTAs for initial margin and variation margin reflects a widespread market practice and would promote consistency with regulations in other jurisdictions.

The CFTC requests comment on (i) whether separate MTAs for initial margin and variation margin is appropriate, given that the approach could result in less margin exchanged; and (ii) whether separate MTAs should also be allowed for SMAs of a counterparty, where a $50,000 MTA would apply.

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Notes

[1] For a summary of the recommendations, *please see* ICI Memorandum No. 32474 (May 21, 2020), *available at* https://www.ici.org/my_ici/memorandum/memo32474.

[2] Phase 6 entities are CSEs and financial end-users with more than $8 billion in average aggregate notional amount (AANA).

[3] The CFTC recently proposed to extend the compliance date for Phase 6 entities for an additional year to September 1, 2022, consistent with the revisions to the BCBS/IOSCO Framework. ICI joined several other trade associations in submitting a comment letter to the CFTC in support of the proposed extension. *See* ICI Memorandum No. 32664 (Aug. 6, 2020), *available at* https://www.ici.org/my_ici/memorandum/memo32664.

[4] The CFTC also notes that the proposed alignment with the BCBS/IOSCO Framework would create a divergence from the US prudential regulators' current approach, which could increase the potential for calculation errors for US-located entities.

[5] Commissioner Berkovitz expressed these concerns in a statement supporting the issuance of the proposal. Statement of Commissioner Dan M. Berkovitz Regarding Notices of Proposed Rulemaking for Certain Matters Related to Margin for Uncleared Swaps (Aug.

14, 2020), *available at* https://www.cftc.gov/PressRoom/SpeechesTestimony/berkovitzstatement081420.

[6] CFTC Letter No. 19-29 (Dec. 19, 2019), *available at* https://www.cftc.gov/csl/19-29/download.

[7] The CFTC notes that other conditions in Letter No. 19-29, *e.g.*, risk management and documentation requirements, would continue to apply through other existing Commission regulations.

[8] CFTC Letter No. 17-12 (Feb. 13, 2017), *available at* https://www.cftc.gov/csl/17-12/download; CFTC Letter No. 19-25 (Dec. 6, 2019), *available at* https://www.cftc.gov/csl/19-25/download.

[9] An SMA would be defined under 23.151 as an account of a counterparty to a CSE that is managed by an asset manager pursuant to specific grant of authority to such asset manager under an investment management agreement between the counterparty and the asset manager, with respect to a specified portion of the counterparty's assets. Further, the SMA definition would require that a SMA's swaps be (i) entered into between the counterparty and the CSE by the asset manager pursuant to the authority given in the agreement; and (ii) subject to a master netting agreement that does not provide for netting across all SMAs of the counterparty that have swaps outstanding with the CSE.

[10] As defined under the proposed MTA definition, the applicable MTA would be either $500,000 or $50,000 for each SMA.