INVESTMENT COMPANY INSTITUTE

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CFTC Issues Proposed Amendments to Uncleared Swaps Margin Requirements Relating to Seeded Funds and Certain Money Market Funds

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August 04, 2023

TO: Derivatives Markets Advisory Committee RE: CFTC Issues Proposed Amendments to Uncleared Swaps Margin Requirements Relating to Seeded Funds and Certain Money Market Funds

On July 26, the CFTC proposed certain amendments[1] to its initial margin (IM) requirements for swap dealers (SDs) and major swap participants (MSPs) (collectively, covered swap entities or "CSEs") regarding seeded funds[2] and money market funds (MMFs). The Proposal would implement, with certain modifications, two recommendations in the CFTC's Global Markets Advisory Committee's (GMAC) 2020 subcommittee report on UMR scoping and implementation.[3]

Comments on the Proposal are due to the CFTC 60 days after publication in the Federal Register. ICI anticipates submitting a comment letter on the Proposal and has scheduled a members-only call on Tuesday, August 15 from 2:30-3:30 pm ET to discuss potential comments. We will send you an Outlook calendar invitation for the call.

Exception for Seeded Funds

The CFTC proposes to amend the definition of "margin affiliate" under CFTC Regulation 23.151 to provide that a seeded fund that meets certain specified conditions ("eligible seeded fund") would be deemed not to have any margin affiliates for purposes of calculating a fund's material swaps exposure (MSE) and the IM exposure threshold amount,[4] for a period of three years from the fund's trading inception date. The Proposal notes that this exception would effectively relieve CSEs that enter into uncleared swaps with an eligible seeded fund from the requirement to exchange IM with such a fund for three years after the fund's trading inception date.

Under the proposed exception, uncleared swaps entered into between a CSE and an eligible seeded fund during the three-year period would continue to be relieved from the IM requirement after expiration of such period. At the end of the three-year period, a fund that meets the accounting standards for consolidation (i.e., due to a sponsor entity holding a significant equity stake in the fund) would be deemed to have margin affiliates whose uncleared swaps exposure must be included for purposes of determining whether the fund has MSE.

An "eligible seeded fund" would be a collective investment vehicle that has received all or part of its start-up capital from a parent and/or affiliate (each, a sponsor entity) where:

1. The fund is a distinct legal entity from each sponsor entity;
2. One or more of the fund's margin affiliates is already required to post and collect initial margin pursuant to CFTC Regulation 23.152;[5]
3. The fund is managed by an asset manager pursuant to an agreement that requires the fund's assets to be managed according to a specified written investment strategy;
4. The fund's asset manager has independence in carrying out its management responsibilities and exercising its investment discretion, and to the extent applicable, has independent fiduciary duties to other investors of the fund;
5. The fund's written investment strategy includes a written plan for reducing each sponsor entity's ownership interests in the fund that stipulates divestiture targets over the three-year period after the seeded fund's trading inception date;
6. Regarding any of the seeded fund's obligations, the fund is not collateralized, guaranteed, or otherwise supported, directly or indirectly, by any sponsor entity, any margin affiliate of any sponsor entity, other collective investment vehicles, or the fund's asset manager;
7. The fund has not received any of its assets, directly or indirectly, from an eligible seeded fund that has relied on the proposed exception; and
8. The fund is not a securitization vehicle.

In proposing these conditions, some of which are additional to those recommended in the GMAC Subcommittee's Report, the CFTC seeks to ensure that eligible seeded funds are sufficiently independent and risk-remote from other entities in their group, such that it justifies treating them separately for purposes of determining whether the IM thresholds have been met.[6] Moreover, while the CFTC notes that the proposed exception is consistent with the approach in other countries and with the BCBS/IOSCO Framework, the Proposal recognizes that the proposed exception would be a departure from the prudential regulators' approach.[7]

The CFTC requests comments on all aspects of the exception.[8] Notably, this includes seeking comment on whether it should proceed with the exception for seeded funds if the prudential regulators do not adopt similar regulatory changes, whether the proposed exception is appropriate in light of the resulting uncollateralized swap risk, and whether the CFTC should impose any additional limits or conditions to the exception.[9]

Money Market Funds as Eligible Collateral

The Proposal would amend CFTC Regulation 23.156(a)(1) to eliminate the asset transfer restriction that currently disqualifies MMFs from being used as eligible collateral—those whose holdings are limited to US Treasuries (or securities unconditionally guaranteed by the US Treasury), and cash funds denominated in US dollars or similar quality government securities—if they engage in repurchase or similar arrangements.[10] The CFTC believes that other existing CFTC regulatory safeguards would adequately address the risks associated with repurchase and similar arrangements, even absent the asset transfer restriction.[11] Further, the CFTC notes that the asset transfer restriction is severely limiting the use of MMF securities as eligible collateral.[12]

The CFTC lists several reasons for proposing the amendment, including: (i) MMFs are regulated short-term vehicles subject to liquidity and diversification requirements; (ii) the MMFs that could qualify as eligible collateral invest in high-quality underlying instruments; (iii) the CFTC has recognized MMFs as safe, high quality investments;[13] (iv) eliminating such asset transfer restriction would allow for a broader range of MMF securities to qualify as eligible IM collateral;[14] and (v) unless the restriction is eliminated, MMFs as a form of margin collateral would be of very limited availability to swap counterparties, contrary to the CFTC's intent when it adopted the CFTC Margin Rule.

Further, the Proposal would amend the haircut schedule in CFTC Regulation 21.156(a)(3) to "add a footnote that was inadvertently omitted when the rule was originally promulgated."[15] The footnote would describe the haircut applicable to MMF securities and would be consistent with a footnote in the prudential regulators' own margin rules.[16]

The CFTC requests comments on all aspects of the proposed elimination of the asset transfer restriction for MMFs.[17] Notably, this includes seeking comment on whether the CFTC should: allow MMF securities to qualify as eligible collateral only if the funds' repurchase or similar arrangements are cleared; impose an additional haircut beyond that already required under the CFTC Regulation 23.156(a)(3); and/or cap the amount of assets a fund can use for repurchase or similar arrangements.[18]

Effective Date

The CFTC states that it intends for any final rule adopted from this proposal to become effective 30 days after publication in the Federal Register. The Proposal requests comments regarding such an effective date.

Nhan Nguyen
Assistant General Counsel, Securities Regulation

Nicolas Valderrama
Counsel

Notes

[1] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants (July 26, 2023) ("Proposal" or "Proposing Release"), available at https://www.cftc.gov/media/9071/votingdraft072623_17CFRPart23/download.

[2] Seeded funds refers to collective investment vehicles ("investment funds" or "funds") that receive all their start-up capital, or a portion thereof, from a sponsor entity.

[3] Recommendations to Improve Scoping and Implementation of Initial Margin Requirements for Non-Cleared Swaps, Report to the CFTC's Global Markets Advisory Committee by the Subcommittee on Margin Requirements for Non-Cleared Swaps (May 2020) ("GMAC Subcommittee Report"), available at https://www.cftc.gov/media/3886/GMAC_051920MarginSubcommitteeReport/download. For

a summary of the GMAC Subcommittee Report, see ICI Memorandum No. 32474, available at https://www.ici.org/memo32474.

[4] CSEs are required to exchange IM with each counterparty that is a SD, MSP, or financial end user with "material swaps exposure" (collectively, "covered counterparties"). An entity has MSE when, together with its "margin affiliates," it has an average aggregate notional amount of exposure ("AANA") in certain uncleared derivatives that exceeds $8 billion over a prescribed period. The regulatory definition of "margin affiliates" is based on financial accounting concepts to determine whether an entity has control over another entity.

[5] The CFTC notes that notwithstanding the proposed exception, CSEs would still be required to count the uncleared swaps they undertake with eligible seeded funds when calculating their own AANA.

[6] Conditions (1) and (3)-(6) are intended to ensure that the sponsor entity does not retain a level of influence or exposure that is materially above that of other minority or passive investors, and that the fund has a genuine plan to emerge from the seeding phase. Condition (2) is designed to ensure that the eligible seeded fund exception targets those funds that, absent amendments to the CFTC Margin Rule, would have to exchange IM due to their consolidation with a group that exceeds the thresholds triggering compliance with the IM requirements. Condition (7) aims to ensure that the three-year period contemplated by the exception is not reinstated due to rollovers or similar activities. Condition (8) is designed to further limit the proposed exception only those seeded funds referenced in the GMAC Subcommittee Report's recommendations. Proposal at 20-21.

[7] See Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 74840 (Nov. 30, 2015) ("Prudential Regulators Margin Rule"), available at https://www.govinfo.gov/content/pkg/FR-2015-11-30/pdf/2015-28671.pdf. The Prudential Regulators Margin Rule contains a definition of "affiliate" that is the equivalent to the current definition of "margin affiliate" under the CFTC Margin Rule.

[8] Proposal at 26-29, Request for Comment 1-9.

[9] Proposal at 28, Request for Comment 1, 3, 8.

[10] The CFTC Margin Rule currently limits the types of collateral eligible to be used for IM. The securities of certain MMFs that invest in high-quality underlying instruments, including securities issued or unconditionally guaranteed as to the timely payment of principal and interest by the US Department of Treasury and cash, may qualify as eligible collateral. The rule also specifies, however, that the fund's asset manager may not transfer the fund's assets through securities lending, securities borrowing, repurchase agreements, or other means that involve having rights to acquire the same or similar assets from the transferee.

[11] The Proposal notes that such safeguards include: (i) CFTC Regulation 23.156(a)(1)(ix)(A) and (B) which qualify as eligible collateral the securities of MMFs that invest in certain high-quality underlying instruments and which effectively limit the types of assets that such a MMF can receive in repurchase or similar arrangements; (ii) CFTC Regulation 23.156(c), which requires that CSEs monitor the market value and eligibility of all collateral and, if the market value declines, to promptly collect or post additional eligible collateral to maintain compliance with the CFTC Margin Rule; and (iii) CEA Section 4s(j)(2), which requires CSEs to adopt a robust and professional risk management system that is adequate for the management of their swap activities. Proposal at 37-39.

[12] Proposal at 39. The CFTC also notes that the proposed amendment would bring the CFTC's margin collateral framework more in line with the SEC's approach, which does not impose asset transfer restrictions on funds whose securities are used as collateral for margining purposes and permits the use of government MMF securities as collateral.

[13] The GMAC Subcommittee Report indicated that, for example, CFTC Regulation 1.25 permits futures commission merchants (FCMs) to invest customer margin in MMFs without an asset transfer restriction. Nevertheless, the CFTC believes that such an example is not dispositive in considering the Money Market Funds Proposal because CFTC Regulation 1.25 was adopted under a different regime (concerning FCMs and derivatives clearing organizations) and addresses different concerns than those targeted by CFTC Regulation 23.156. see Proposal at 31, n.67.

[14] The CFTC notes that if adopted, the proposed amendment would also result in an expanded scope of MMF securities that can serve as variation margin (VM) for uncleared swap transactions between a CSE and a financial end user, given that CFTC Regulation 23.156(b)(1)(iii), which defines the types of assets qualifying as VM collateral for these transactions, incorporates the assets identified as eligible collateral for IM in CFTC Regulation 23.156(a)(1).

[15] Proposal at 29, 39-40.

[16] The footnote would specify that the haircut for such MMF securities would be the weighted average discount on all assets within the funds at the end of the prior month, and that the weights to be applied in the weighted average should be calculated as a fraction of each fund's total market value that is invested in each asset with a given discount amount.

[17] Proposal at 40-43.

[18] Proposal at 40-43, Request for Comment 11-13.