

Overview of US Margin Requirements for Uncleared Swaps

On October 22, 2015, the Board of the Federal Deposit Insurance Corporation ("**FDIC**") and the Office of the Comptroller of the Currency (the "**OCC**") approved the text of a final joint rule that will impose minimum margin requirements for uncleared swaps that involve swap dealers and major swap participants regulated by US bank regulators (collectively referred to as "**covered swap entities**" or "**CSEs**") (the "**Final Rule**", available [here](#)). The Final Rule is the result of a joint rulemaking process involving five prudential regulators of US financial institutions, including the FDIC, the Federal Reserve and the OCC (collectively, the "**Prudential Regulators**"). The Prudential Regulators that have not yet approved this rule are expected to do so in the coming days.

The Final Rule contains exemptions for certain end users and will not apply to swap dealers and major swap participants that are not regulated by any of the Prudential Regulators. Instead, such swap entities will be subject to minimum margin requirements to be adopted by the Commodity Futures Trading Commission (the "**CFTC**") with respect to swap dealers and those to be adopted by the Securities and Exchange Commission (the "**SEC**") with respect to security-based swap dealers. These two agencies have not yet adopted implementing regulations.

Background

The Final Rule implements Sections 731 and 764 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "**Dodd-Frank Act**") by specifying the circumstances in which margin will be required to be posted and collected. It also provides guidance with respect to the methodologies for the calculation of margin amounts and determination of the value of margin collateral.

The Terrorism Risk Insurance Program Reauthorization Act of 2015 amends sections 731 and 764 of the Dodd-Frank Act to exempt qualifying transactions of certain counterparties from US minimum margin requirements. The Prudential Regulators are

also adopting an Interim Final Rule ("IFR", available [here](#)) to implement these exemptions. This briefing describes both the Final Rule and the IFR.

In developing the Final Rule, the Prudential Regulators took into consideration the recommendations embodied in the international framework for margin requirements on non-cleared derivatives developed by the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions (the "**2013 International Framework**", available [here](#)).

While the effective date of the Final Rule is April 1, 2016, covered swap entities will become subject to variation margin requirements between September 1, 2016 and March 1, 2017. Initial margin requirements will begin to apply between September 1, 2016 and September 1, 2020. These phase-in dates coincide with the target implementation dates specified in the 2013 International Framework. The compliance dates will depend on the average daily aggregate notional amount of covered swaps between the swap entity (combined with its affiliates) and a particular counterparty of the swap entity (combined with its affiliates).

Variation Margin Phase-In

Average Daily Aggregate Notional Amount Criteria	Compliance Date
Both the covered swap entity combined with all its affiliates and its counterparty combined with all its affiliates have an average daily aggregate notional amount of covered swaps for March, April and May of 2016 that exceeds \$3 trillion	September 1, 2016
Any covered swap entity with respect to covered swaps with any other counterparty	March 1, 2017

Initial Margin Phase-In

Average Daily Aggregate Notional Amount Criteria	Compliance Date
Both the covered swap entity combined with all its affiliates and its counterparty combined with all its affiliates have an average daily aggregate notional amount of covered swaps for March, April and May of 2016 that exceeds \$3 trillion	September 1, 2016
Both the covered swap entity combined with all its affiliates and its counterparty combined with all its affiliates have an average daily aggregate notional amount of covered swaps for March, April and May of 2017 that exceeds \$2.25 trillion	September 1, 2017
Both the covered swap entity combined with all its affiliates and its counterparty combined with all its affiliates have an average daily aggregate notional amount of covered swaps for March, April and May of 2018 that exceeds \$1.5 trillion	September 1, 2018
Both the covered swap entity combined with all its affiliates and its counterparty combined with all its affiliates have an average daily aggregate notional amount of covered swaps for March, April and May of 2019 that that exceeds \$0.75 trillion	September 1, 2019
Any covered swap entity with respect to covered swaps with any other counterparty	September 1, 2020

Scope of Minimum Margin Requirements

The applicability of the Final Rule depends on the type of swap as well as the classification of the parties to the swap.

What types of swaps will be affected by the Final Rule?

The Final Rule will impose minimum margin requirements on uncleared swaps and uncleared security-based swaps that are entered into by CSEs. These requirements will not apply to swaps that are cleared by a derivatives clearing organization that is either registered with, or has received an exemption from, the CFTC. Physically-settled foreign exchange forwards and swaps will not fall within the scope of the margin requirements. Furthermore, the Final Rule will not apply retroactively to pre-existing swaps.

What types of swap parties would be subject to US margin requirements?

Whether a CSE is required to comply with US minimum margin requirements with respect to any given swap depends not only on the type of swap, as discussed above, but also on the type of counterparty. The Final Rule distinguishes between four types of counterparties:

- **Swap entities.** This category includes swap dealers and major security-based swap participants that are registered with the CFTC.¹
- **Financial end users with material swaps exposure.** A financial end user would have "**material swaps exposure**" if that entity and its affiliates as a group, on a consolidated basis, have an average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange forwards and foreign exchange swaps for June, July and August of the previous calendar year that exceeds \$8 billion. Transactions between entities and their affiliates should only be counted once, and swaps with clearing-exempt end users that are exempt under the IFR need not be included in the calculation. The Final Rule provides a definition of "affiliate" for purposes of this calculation, which is based on accounting standards.
- **Financial end-users without material swaps exposure.**
- **Other counterparties.** This category includes end users that are exempt under the U.S. clearing rules (referred to as "**clearing-exempt end users**"), non-financial end users, sovereigns, and multilateral development banks.

Who is a "Financial End User"?

The Final Rule provides an extensive list of non-swap entities that are deemed to be "**financial end users**" and excludes specified types of entities from the definition of this term. For example, U.S. intermediate holding companies, floor brokers, floor traders and introducing brokers will all be considered to be financial end users. The definition also covers pooled investment vehicles and other entities or persons that primarily engage in trading, investing or in facilitating the trading or investing in loans, securities, swaps, funds or other assets. Any non-US entity that would qualify as a "financial end user" if it were established in the United States is included in the definition as well. In the future, the Prudential Regulators may consider another rulemaking to amend this definition if they find that additional types of financial entities should be classified as financial end users.

¹ This category will extend to security-based swap dealers and security-based major swap participants when they are required to register with the SEC.

The Final Rule does not specifically exclude structured financial vehicles or covered bond issuers from the definition of "financial end user". Swap entities that deal with REITs, securitization vehicles or other similar entities will need to undertake an analysis of the counterparty's business activities to evaluate whether the counterparty would qualify as a "financial end user".

The definition of financial end user excludes:

- sovereigns;
- multilateral development banks;
- the Bank for International Settlements;
- any captive finance company or agent affiliate that qualifies for an exemption from clearing under the Commodities Exchange Act of 1936, as amended (the "CEA"), and related sections of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and the related implementing regulations.

Exemption for Clearing-Exempt End Users

Transactions with clearing-exempt end users are exempt from the Final Rule under the IFR. Specifically, U.S. minimum margin requirements will not apply to uncleared swaps and uncleared security-based swaps entered into by a CSE with any of the following types of counterparties that qualify for an exemption from U.S. swap clearing requirements:

- commercial end users;
- small banks or financial institutions;
- cooperatives; and
- captive finance companies and agent affiliates.

Variation Margin

The Final Rule requires a bilateral exchange of variation margin between CSEs and other swap entities or financial end users. CSEs that enter into swaps with other swap entities or financial end users will be required to collect or post (as applicable) variation margin, unless the total amount of initial and variation margin does not exceed \$500,000. Variation margin obligations do not differ between financial end users with material swaps exposure and those that do not have such exposure.

How will variation margin be calculated and posted?

Variation margin is calculated as the cumulative mark-to-market change in value of the swap to the swap entity (measured from the date the swap is entered into), less the aggregate value of variation margin previously collected by the swap entity, plus the aggregate value of variation margin previously posted with respect to such swap by the swap entity. The swap entity must collect this amount if the amount is positive, and post this amount if the amount is negative.

The Final Rule requires variation margin to be collected or posted (as applicable) at least once per business day, beginning on the business day following the day of execution. (The day of execution is the trade date adjusted for time zone differences.) Variation margin may be netted if executed pursuant to an eligible master netting agreement (as discussed below). Variation margin need not be segregated and may be re-hypothecated.

Initial Margin

Which entities will be required to collect and post initial margin?

Whether a CSE will be required to collect and post initial margin will depend on the type of counterparty to such swap. If the counterparty is also a swap entity, then both parties to the swap will be required to collect initial margin from each other. If the counterparty is a "financial end user" but not a swap entity, then the CSE will be required to collect and post initial margin only if the counterparty has material swaps exposure.

How will initial margin be calculated?

The Final Rule provides for two possible methods for calculating the minimum required amount of initial margin: use of a model or a standardized schedule-based approach. Regardless of the method used, CSEs will need to monitor initial margin obligations on a daily basis and collect and/or post additional collateral, as applicable. The initial margin must be delivered on the business day following the date of execution.

Model. A CSE will be permitted to use a model to determine initial margin amounts if it has obtained approval from its relevant Prudential Regulator. Models should calculate initial margin amounts based on a one-tailed 99% confidence interval over a horizon equal to the lesser of 10 business days or the remaining maturity of the swap and a historical observation period of one to five years. These models would need to be reviewed at least annually and recalibrated as necessary. Models would be required to include all material risks arising from nonlinear price characteristics and the sensitivity of the market value of positions to changes in the volatility of the underlying rates, prices, or other material risk factors.

Schedule-based method. If a CSE does not use an initial margin model, it is required to use a standardized margin schedule to calculate initial margin as a percentage of the notional amount of the swap (ranging from 2% to 15%, depending on the type of swap). When multiple uncleared swaps are subject to an eligible master netting agreement, the calculation of the initial margin amount using this method contemplates a net-to-gross adjustment based on a specified formula.

What exemptions will be available to the initial margin requirements?

In addition to the exceptions discussed earlier, the Final Rule provides two key exemptions from the margin requirements: one based on a bilateral threshold and another based on a minimum transfer amount. Under a bilateral threshold, a swap entity would not be required to collect initial margin if the value of uncleared swaps between the two entities (calculated on a consolidated group basis for each, if applicable) is less than \$50 million.

CSEs are also permitted to take advantage of an exemption related to minimum transfer amounts. Specifically, swap entities would not be required to collect or post margin unless the total amount of margin (both initial and variation margin combined) exceeds \$500,000. The minimum transfer amount would not change the amounts required to be collected once the threshold has been exceeded.

How will initial margin collateral need to be held?

The Final Rule requires that all margin (other than variation margin) posted by a CSE be segregated and held by a third party custodian. This segregation requirement applies to any collateral (other than variation margin) posted by a CSE, even when such collateral exceeds the minimum amount required to be posted. For margin collected by a CSE, however, the segregation requirements apply only to the minimum amount of initial margin required to be collected under the Final Rule.

The collateral must be held by a third party custodian that is not affiliated with either party to the swap. The agreement with the third party custodian will need to contain provisions that prohibit re-hypothecation or re-pledging of the collateral that constitutes the initial margin, and such provisions must be enforceable in bankruptcy. Such agreement may provide that cash collateral be

held in a general deposit account with the custodian if the funds in the account are used to purchase qualifying assets, such assets are segregated, and such purchase takes place within a time period reasonably necessary to consummate such purchase after the cash collateral is posted as initial margin.

Will netting be permitted?

The Final Rule permits netting of swaps for variation margin purposes if the parties use an eligible master netting agreement. With respect to initial margin, the Final Rule permits netting of swaps by CSEs that use the schedule-based method to calculate initial margin when an eligible master netting agreement applies. For CSEs that use a model to calculate initial margin amounts, netting of swaps pursuant to an eligible master netting agreement is permitted only within asset classes.

In the absence of an eligible master netting agreement, a CSE must treat uncleared swaps on a gross basis for purposes of collecting margin, but it may net those swaps for purposes of calculating and complying with requirements to post margin.

The eligible master netting agreement. Netting will only be permitted by market participants that use an eligible master netting agreement. In order to be eligible, a master netting agreement will need to:

- provide for the creation of a single obligation upon default;
- only be subject to limited stays in insolvency; and
- not contain any walkaway clauses.

The swap entity will need to have a well-founded legal basis that such an agreement meets these requirements.

A swap entity may use a single master netting agreement for multiple netting portfolios. Swaps entered into with a counterparty prior to the compliance date (referred to as "**legacy swaps**") may be included in a netting portfolio of exclusively legacy swaps, which would be exempt from the margin requirements. However, if legacy swaps are included in a netting portfolio with new swaps, both the legacy swaps and the new swaps would be subject to the margin requirements.

Eligible Collateral and Haircuts

Eligible Collateral

Variation margin. For swaps and security-based swaps between a CSE and another swap entity, permitted collateral for variation margin is cash (in the form of U.S. dollars, any other major currency or the settlement currency of the swap). For swaps and security-based swaps between a CSE and a financial end user, permitted collateral is the same as is permitted for initial margin.

Initial margin. Permitted collateral for initial margin purposes includes:

- cash (in the form of U.S. dollars, any other major currency or the settlement currency of the swap);
- U.S. Treasury and agency securities;
- securities issued by the European Central Bank or sovereign with a capital risk weighting of 20% or less;
- publicly traded debt securities issued or asset-backed securities guaranteed by U.S. government sponsored enterprises (GSEs) operating with U.S. government support;
- publicly traded debt securities issued by GSEs not operating with U.S. government support that are determined to be "investment grade" as defined by the relevant regulator;
- securities issued or guaranteed by the Bank for International Settlements, the International Monetary Fund or a multilateral development bank;
- publicly traded debt securities determined to be "investment grade" as defined by the relevant regulator;

- publicly traded equity listed on certain indices;
- certain redeemable government bond funds; and
- gold.

The Final Rule specifies that certain assets may not be used for initial margin collateral. These include any asset that is an obligation of the party providing such asset or an affiliate of that party as well as instruments issued by bank holding companies, depository institutions, market intermediaries and designated non-bank systemically important financial institutions.

Haircuts

The Final Rule provides standardized haircuts for the valuation of non-cash collateral posted for initial and variation margin. The haircuts vary depending on asset class and maturity. For certain government bonds, the haircut ranges from 0.5% to 4.0 %, depending on maturity. For agency and corporate bonds, the haircut ranges from 1% to 8%. For equities and gold the haircut ranges from 15% to 25%.

Also, a cross-currency haircut of 8% applies to collateral posted for initial and variation margin that is denominated in a currency other than the currency of settlement of the relevant swap or security-based swap. When applicable, the cross-currency haircut is in addition to the standardized haircut. The cross-currency haircut does not apply to:

- variation margin in the form of cash denominated in a major currency, or
- initial margin denominated in a single termination currency designated as payable to the non-posting counterparty as part of the eligible master netting agreement.

Inter-Affiliate Transactions

US minimum margin requirements generally apply to uncleared swaps and security-based swaps between a CSE and any of its affiliates. The Final Rule modifies, however, certain aspects of these requirements for inter-affiliate transactions.

Variation margin. CSEs must collect and post variation margin from affiliate counterparties that are swap entities and financial end users, regardless of their level of swaps exposure.

Initial margin. CSEs must collect initial margin from affiliate counterparties that are swap entities and financial end users with material swaps exposure, subject to an initial margin threshold of \$20 million. CSEs are not required to post initial margin to affiliate counterparties, but for uncleared swaps and security-based swaps with affiliates that are financial end users with material swaps exposure, the covered swap entity must calculate the amount of initial margin that it would otherwise have been required to post and provide documentation of that amount to the affiliate on a daily basis.

If a CSE uses the standard schedule to determine initial margin amounts, the rates are to be multiplied by a factor of 0.7 (i.e., a discount of 30% applies). If the CSE uses a model, for uncleared swaps that would be subject to the clearing requirement but for an exception (e.g., swaps subject to the inter-affiliate exemption from clearing), the model may use a holding period equal to the shorter of five business days or the maturity of the swap, security-based swap or netting portfolio, as applicable. If a netting portfolio includes such swaps, such netting portfolio must be identified and separate from other netting portfolios for purposes of compliance with the initial margin requirements.

Initial margin collected by a CSE from an affiliate in the form of non-cash collateral must still be held at a custodian, but the custodian may be the CSE or an affiliate.

Documentation

The Final Rules require that the swap agreement specify methods and inputs for determining swap values for variation margin and initial margin and related dispute resolution procedures.

A covered swap entity will be required to execute documentation with a counterparty that is a swap entity or a financial end user regarding credit support arrangements that provides contractual rights to post and collect initial margin and variation margin as required by the rule. All margin documentation (including margin documentation with a non-financial entity) will need to:

- specify the methods, procedures, rules, and inputs used to value swaps for purposes of calculating variation margin;
- provide procedures for the resolution of disputes concerning the valuation of swaps or collateral; and
- describe the methods, procedures, rules, and inputs used to value swaps for purposes of calculating initial margin.

Crossborder Application

Excluded non-U.S. swaps. The Final Rule provides a general exclusion for non-U.S. swaps of non-U.S. swap entities. To be considered a non-U.S. swap eligible for such exclusion, neither the counterparty nor any party that provides a guarantee of either party's obligations under the swap may be:

- an entity organized under U.S. law;
- a natural person who is a resident of the United States;
- a non-U.S. branch or office of an entity organized under U.S. law; or
- a swap entity that is a subsidiary of an entity organized under U.S. law.

Only a CSE that is organized under the laws of a non-U.S. jurisdiction and is not a subsidiary of a U.S. company will be considered a non-U.S. swap entity for purposes of this exclusion.

Substituted Compliance. The Final Rule provides a framework that will permit certain non-U.S. CSEs to apply to the Prudential Regulators for a determination that the minimum margin requirements of a non-U.S. jurisdiction are comparable to the requirements of the Final Rule. The implementation of the 2013 International Framework in a number of major jurisdictions will make it more likely that non-U.S. covered swap entities in those jurisdictions will be able to successfully apply for substituted compliance determinations in the United States.

If the Prudential Regulators make a favorable determination regarding the comparability of the non-U.S. regulatory framework, then any of the following entities would be permitted to comply with those non-U.S. requirements (instead of with the comparable U.S. requirements) with respect to any uncleared swap or security-based swap for which such entity's obligations are not guaranteed by an entity organized under U.S. law, a natural person resident in the United States or a non-U.S. branch or office of an entity organized under U.S. law:

- a CSE that is organized under the laws of a non-U.S. jurisdiction and is not a subsidiary of a U.S. company;
- a U.S. branch or agency of a non-U.S. bank; and
- an entity that is not organized under the laws of the U.S. and is a subsidiary of a U.S. bank, Edge corporation, or agreement corporation.

The Final Rule provides additional, limited regulatory relief for swaps between any swap entity (including a U.S.-based swap entity) and a non-US swap entity that is subject to a foreign regulatory framework that has been determined to be comparable. For these swaps, any swap entity would be deemed to satisfy its posting requirement under the Final Rule by posting (in amount, form, and at such time) as required by the counterparty's comparable non-U.S. margin collection requirement, so long as the non-U.S. counterparty does not have a U.S. guarantor.

Application may be made for additional relief for non-U.S. operations where segregation is unavailable. The Final Rule recognizes that the segregation of margin collateral may not be possible in certain non-U.S. jurisdictions. The Final Rule specifies the criteria that must be met before the Prudential Regulators may grant a written application for exemptive relief from U.S. collateral segregation requirements in circumstances where swap entities face limitations in the legal or operational infrastructure in a non-U.S. jurisdiction that make it impracticable to comply with the U.S. collateral segregation requirements. To be eligible for relief, a CSE must be subject to legal restrictions in the relevant non-U.S. jurisdiction that require it to transact in the relevant swap with the counterparty within such non-U.S. jurisdiction and do not accommodate the posting of collateral for such swap outside the jurisdiction.

Conclusion

The Final Rule will generally require a two-way exchange of margin by many market participants. While U.S. minimum margin requirements for uncleared swaps are largely consistent with international standards, implementation will likely present numerous practical challenges, including documentation, development of collateral systems, and development of initial margin models.

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