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Dodd-Frank: CFTC and Prudential Regulators Release Proposed Margin Requirements for Uncleared Swaps

Overview

On April 12, 2011, the Department of the Treasury, the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency (collectively, the "Prudential Regulators") proposed rules under Sections 731 and 764 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") that would establish minimum initial and variation margin requirements for uncleared swaps entered into by swap dealers, security-based swap dealers, major swap participants and major security-based swap participants (collectively, "Swap Entities") that are banks or are subject to regulation by a Prudential Regulator (the "Prudential Regulators' Proposal").[1]

On the same day, the Commodity Futures Trading Commission (the "CFTC") proposed its own rules that would establish minimum initial and variation margin requirements for uncleared swaps entered into by Swap Entities that fall within the regulatory oversight of the CFTC (the "CFTC Proposal" and, together with the Prudential Regulators' Proposal, the "Proposed Rules").

The two Proposed Rules are largely similar in a number of respects. As expected, the Proposed Rules would require significant changes from current market practice for posting margin for uncleared swaps, including as to who has to post, how much margin is required and how it is calculated, what kind of margin is eligible to be posted, and how margin is held. Some highlights include:

- Margin requirements do not apply retroactively, i.e. to swaps entered into before effective date
- Swap Entities must post and collect initial and variation margin from other Swap Entities and must segregate that initial margin with third-party custodian
- Swap Entities must collect (not post) initial and variation margin from financial end-users, subject in certain circumstances to permissible thresholds

[1] The Prudential Regulators' Proposal also addressed capital requirements for Swaps Entities that are subject to their oversight. The Prudential Regulators' Proposal would require Swap Entities subject to their oversight to comply with existing capital standards that apply to them under existing rules set by their respective Prudential Regulator.

- Swaps with non-financial end-users are treated slightly differently under the two Proposed Rules

A key question among market participants since the enactment of Dodd-Frank has been whether, or the extent to which, end-users that are not Swap Entities, particularly non-financial end-users, would be required to post margin. The Proposed Rules take different approaches on this issue, although under both many non-financial end-users would not be required to post margin. Another area of concern has been the scope of extraterritorial application of the margin rules. Although the proposals have some exceptions for swap activities between non-U.S. entities, a wide range of transactions between non-U.S. entities (including sovereign entities) and U.S. Swap Entities may be captured by the Proposed Rules.

The Prudential Regulators and the CFTC have requested comments on a number of topics set out in the Proposed Rules. Comments on the Prudential Regulators' Proposal are due June 24, 2011. The CFTC has not yet set a deadline for comments to the CFTC Proposal, but it is expected that the comment period for the CFTC Proposal will run concurrently with the comment period for the CFTC's rule proposal on capital requirements applicable to Swap Entities which is expected to be released as of the date of this Client Alert. It should be noted that as of the date of this Client Alert, the Securities and Exchange Commission ("SEC") has not yet issued its own proposed rules on margin requirements for uncleared security-based swaps entered into by Swap Entities subject to SEC oversight.

This Client Alert summarizes the key components of the Proposed Rules and sets out the salient differences between them. Appendix I attached hereto is a matrix which highlights key requirements set out in the Proposed Rules.

Background

Title VII of Dodd-Frank amended the Commodity Exchange Act ("CEA") and the Securities Exchange Act of 1934 (the "Exchange Act") to establish a robust regulatory framework to reduce risk, increase transparency, and promote market integrity in the financial system by, among other things, providing for the registration and regulation of swap dealers, security-based swap dealers, major swap participants and major security-based swap participants. Sections 731 and 764 of Dodd-Frank, which add a new Section 4s to the CEA and Section 15F to the Exchange Act, respectively, require the adoption of rules establishing margin requirements applicable to Swap Entities for uncleared swaps to address the increased risk that such swaps may pose to the financial system and its participants. The Prudential Regulators are required to establish rules for Swap Entities that are subject to their respective oversight and the CFTC and SEC are required to establish rules applicable to Swap Entities within their respective oversight for which there is no Prudential Regulator. This split regulatory structure could result in entities within the same financial group being subject to different rules. For example, the Federal Reserve Board is the prudential regulator for bank holding companies and foreign banks treated as bank holding companies, including subsidiaries of these bank holding companies and foreign banks. However, non-bank subsidiaries of bank holding companies that register as swap dealers or major swap participants would be subject to the CFTC's and/or SEC's rules, while bank subsidiaries would be subject to the rules of the Prudential Regulators.

Title VII requires, among other things, that the Prudential Regulators, CFTC and SEC establish and maintain, to the maximum extent practicable, comparable minimum initial and variation requirements for Swap Entities and requires the regulators to consult with each other at least annually on such requirements. The statutory mandate for such requirements is set out in newly added CEA Section 4s(e)(3) and Exchange Act Section 15F(e), which require that the CFTC, SEC, and Prudential Regulators adopt capital and margin requirements that: (1) help ensure the safety and soundness of the registrant; and (2) are appropriate for the risks associated with the uncleared swaps they hold.

Margin Requirements under the Proposed Rules

The Proposed Rules apply only to uncleared swaps executed after the effective dates of the Proposed Rules[2] and impose differing margin requirements depending on the type of counterparty as set out in more detail below.

Uncleared Swaps Between Swap Entities

In a significant departure from current market practice, the Proposed Rules require Swap Entities to bi-laterally collect and post both initial and variation margin on uncleared swaps between them. Initial margin must be collected at or before the execution of any uncleared swap, subject to a minimum transfer amount of $100,000. A Swap Entity is not permitted to establish an initial margin threshold amount for other Swap Entities. A margin threshold amount generally refers to an amount of unsecured exposure that a party is willing to accept from its counterparty that, when exceeded, would require the other party to post margin. The Proposed Rules would require that a Swap Entity collect at least the full amount of initial margin that has been calculated for a swap. The Proposed Rules would also require that initial margin (but not variation margin) posted by a Swap Entity be segregated with an independent third-party custodian located in a jurisdiction that applies the same insolvency regime to the custodian as the posting Swap Entity. Moreover, the custodial arrangement must be subject to contractual restrictions on rehypothecation by the parties and the custodian. The custodian is permitted to invest such margin in eligible forms of collateral permissible under the Proposed Rules, e.g Cash, U.S. Treasuries, and certain securities issued by "government-sponsored entities" (See "Eligible Collateral" discussion below). This segregation requirement is likely to impose a significant liquidity burden on Swap Entities.

In addition to initial margin requirements, the Proposed Rules require that Swap Entities bi-laterally post and collect variation margin to/from other Swap Entities no less than once per day, subject to a separate minimum transfer amount of $100,000. Similar to initial margin, a Swap Entity is not permitted to establish a variation margin threshold amount for other Swap Entities. Unlike the initial margin amount, there is no segregation requirement for the variation margin exchanged between Swap Entities.

It is noteworthy that with respect to variation margin only, a Swap Entity would not violate the Proposed Rules in a situation where its counterparty fails to post required variation margin and it:

- makes the necessary efforts to attempt to collect the required variation margin, including the timely initiation and continued pursuit of formal dispute resolution mechanisms, or has otherwise demonstrated to the satisfaction of the CFTC or Prudential Regulator that it has made appropriate efforts to collect the required variation margin; or

[2] The Prudential Regulators note, however, that permitting the use of internal risk models to calculate initial margin on a portfolio basis may result in the retroactive application of margin requirements to pre-effective date swap transactions should a Swap Entity choose to calculate margin on a portfolio basis pursuant to a master netting agreement with its counterparty. As an alternative, the Prudential Regulators have proposed to permit Swap Entities to elect whether to apply its internal model to post-effective date swaps only or to apply such model to all swaps governed by a master netting agreement. The Prudential Regulators have also requested comments on their proposal that would require that Swap Entities apply variation margin requirements to all swaps covered by a master netting agreement regardless of the date in which they were entered into.

- has commenced termination of the swap.

Uncleared Swaps Between a Swap Entity and a "Financial End-User"

The Proposed Rules require Swap Entities to collect (but not pay) initial and variation margin in connection with swap transactions with "financial end-users" or "financial entities" as defined in the Prudential Regulators' Proposal and the CFTC Proposal, respectively. As defined in the Proposed Rules these terms are substantively the same and will be referred to herein as "financial end-users". Subject to certain threshold amounts as discussed in more detail below, initial margin must be collected on or before execution of the swap and variation margin must be collected from a financial end-user no less than once per business day. Segregation of initial margin may be requested by a financial end-user but the Proposed Rules do not require such segregation if not requested. Although not required, nothing in the Proposed Rules would prevent a Swap Entity from providing initial and/or variation margin to its counterparty under the terms of any credit support arrangement.

The Proposed Rules define a financial end-user as:

- a commodity pool as defined in Section 1a(5) of the CEA;
- a private fund as defined in Section 202(a) of the Investment Advisers Act of 1940;
- an employee benefit plan as defined in paragraph (3) and (32) of section 3 of the Employee Retirement Income and Security Act;
- a person predominately engaged in activities that are in the business of banking or in activities that are financial in nature as defined in Section 4(k) of the Bank Holding Company Act of 1956;
- a person that would be a commodity pool or private fund (as described above) if it were organized under the laws of the U.S. or any State thereof;
- a foreign government or political subdivision, agency or instrumentality thereof; or
- other persons as the Prudential Regulators and CFTC, respectively, may so designate.

The financial end-user definition closely follows the definition of "financial entity" as used in the end-user exception to the mandatory clearing requirement set out in Section 2h(7)(c) of the CEA but adds provisions to capture any non-U.S. government entities and non-U.S. private funds and commodity pools.

The Prudential Regulators further distinguish financial end-users as "high-risk" and "low-risk" and permit use of threshold amounts below which initial and variation margin would not need to be collected from "low-risk" financial end-users. The CFTC Proposal utilizes the same approach by providing threshold amounts to "low-risk" financial end-users but does not explicitly distinguish "high-risk" from "low-risk" financial end-users.

A financial end-user would be categorized as "high-risk" unless it can represent that:

- it does not have "significant swap exposure";[3]
- it predominantly uses swaps or security-based swaps to hedge or mitigate risks of its business activities, including balance sheet, interest rate, or other risk arising from the business of the counterparty; and
- it is subject to capital requirements established by a prudential regulator or state insurance regulator.

Because of the last requirement, it seems likely that most funds and non-U.S. government entities would fall into the "high-risk" category, regardless of the level or purpose of their swap trading activity.[4]

Under the Proposed Rules, a "high-risk" financial end-user would have a zero threshold, meaning that the Swap Entity would be required to collect the entire initial and variation margin amount as calculated. For transactions with "low-risk" financial end-users, the Proposed Rules would require a Swap Entity to collect initial and variation margin to the extent that such amount exceeds the lesser of:

- an amount between $15 million and $45 million (to be determined in the final rules); or
- a percentage between 0.1 percent and 0.3 percent of the Swap Entity's tier 1 capital (to be determined in the final rules).[5]

Uncleared Swaps Between a Swap Entity and a "Non-Financial End-User"

As noted above, the Proposed Rules differ on the requirements applicable to swaps with non-financial end-users. The Proposed Rules generally define non-financial end-users to be those entities that are not Swaps Entities and are not "financial entities."

The CFTC Proposal would not impose margin requirements on non-financial end-users but does require that Swap Entities enter into or maintain credit support arrangements with such end-users. The CFTC Proposal does not specify what such

[3] Significant swap exposure means: a swap/security-based swap position equals or exceeds (i) $2.5 billion ($1 billion for security-based swaps) in daily average aggregate uncollateralized outward exposure; or (ii) $4 billion ($2 billion for security-based swaps) in daily average aggregate uncollateralized outward exposure plus daily average aggregate potential outward exposure.

Thresholds are set at 50% of levels that would trigger registration as a major swap participant under the "substantial counterparty exposure" prong of the definition of major swap participant.

[4] The Proposed Rules request comment on whether a separate category of counterparty classification should be created for sovereign counterparties. In treating sovereign counterparties as financial entities, the regulators "preliminarily believe that the financial condition of a sovereign will tend to be closely linked with the financial condition of its domestic banking system, through common effects of the business cycle on both government finances and bank losses, as well as through the safety net that many sovereigns provide to banks." The regulators reason that "such a tight link with the health of its domestic banking system, and by extension with the broader global financial system, makes a sovereign counterparty similar to a financial entity both in the nature of the systemic risk and the risk to the safety and soundness of the Swap Entity."

[5] For entities regulated by Federal Housing Finance Authority or the Farm Credit Administration, the appropriate metric would be total capital and applicable core surplus or core capital, respectively. The CFTC Proposal uses the term "regulatory capital" which is reserved for the time being pending publication of the proposed rules on capital requirements.

credit support arrangements must contain. While the CFTC Proposal requires as a risk management tool that Swap Entities calculate hypothetical initial and variation margin requirements each day for positions held by non-financial end-users, it only requires that the Swap Entities pay and collect initial and variation margin as provided in the agreement with their counterparties. The CFTC Proposal does not appear to limit the parties' ability to disapply margin requirements altogether if agreed between the parties pursuant to the terms of a credit support arrangement.

The Prudential Regulators' Proposal, on the other hand, would require a Swap Entity to determine a credit exposure limit for a non-financial end-user and collect initial and variation margin to the extent that such end-user's credit exposure exceeds the calculated limit. Such collection would likewise be subject to a minimum transfer amount of $100,000. Variation margin amounts would only have to be collected from non-financial end-users on a weekly basis as opposed to a daily basis once the credit limit is reached.

The CFTC justified its proposal by reference to Congressional colloquies and correspondence in which members of Congress stated that it was not their intent to apply margin requirements to non-financial end-users. The Prudential Regulators, while noting that correspondence, also noted that the text of Sections 731 and 764 of Dodd-Frank did not distinguish non-financial end-users from other market participants, and focused on the different levels of risk posed by non-financial end-users as compared to other end-users.

Calculation of Margin Under the Proposed Rules

Initial margin

The Proposed Rules also differ slightly in the methods by which a Swap Entity is permitted to calculate initial margin requirements. The CFTC Proposal provides that a Swap Entity is permitted to calculate initial margin using one of the following models[6]:

- a model used by a derivatives clearing organization for margining cleared swaps,
- a model being used by an entity subject to oversight by a Prudential Regulator used to margin uncleared swaps, or
- a model made available for licensing to any market participant by a vendor.

The CFTC Proposal also provides that if any of the models outlined above are not available, initial margin must be calculated by an alternative model looking at a similarly cleared swap cleared by a derivatives clearing organization or, if there is no cleared swap, a futures contact cleared by a derivatives clearing organization that falls in the asset class most closely resembling the uncleared swap and that would be most likely used to hedge the uncleared swap. In order to determine the

[6] A significant standard set out in the rule proposal is that the model must set margin to cover at least 99% of price changes by product and by portfolio over a ten-day liquidation period.

margin amount for the uncleared swap, the Swap Entity would multiply the initial margin required for the cleared swap by 2.0 or by 4.4 if looking to the cleared futures contract.

By contrast, the Prudential Regulators' Proposal would permit a Swap Entity to calculate initial margin based on either a standardized "look up" table or an internal margining model that has been approved by the relevant Prudential Regulator. The proposed "look up" table determines the minimum amount of initial margin to collect as a percentage of the swap's notional amount[7] and varies depending on the asset class and duration of the swap. Unlike an internal margining model, the "look up" table approach would not permit netting or other offsetting benefits when calculating initial margin requirements on a portfolio basis. Instead, the "look up" table would require collection of initial margin for each individual swap without regard to offsets. Accordingly, it seems unlikely that many Swap Entities will elect to use the "look up" table given the lack of netting on a portfolio basis.

In addition to the "look up" table, a Swap Entity is able to calculate required initial margin based on an internal margining model that has been approved by the relevant Prudential Regulator. Such model must meet certain standards and requirements as prescribed by the Prudential Regulators and be at least as conservative as models employed by derivatives clearing organizations in the calculation of initial margin required in connection with cleared positions. Any internal margining model would also be required to be calibrated to endure periods of market stress during which market participants are more likely to default and shall be reviewed at least annually to address any market developments.

At a minimum, an internal margining model would be required to calculate initial margin based on a measure of potential future exposure at a 99% confidence level over a ten-day time period. The Prudential Regulators' Proposal notes that the ten-day time period is longer than the typical three to five-day period that is typically employed by derivatives clearing organizations. The Prudential Regulators suggest, however, that the longer period is appropriate in the uncleared swap context given that certain uncleared swaps are expected to be less liquid and may require a longer period to unwind.

To the extent that a Swap Entity employs an internal model to calculate initial margin requirements, the Prudential Regulators' Proposal would permit such model to calculate initial margin on a portfolio basis and reflect offsetting exposures, diversification, and other hedging benefits for swaps governed by the same master netting agreement. Offsetting positions and other hedging benefits, however, may only be recognized within each asset category.

Variation margin

The Proposed Rules permit the calculation of variation margin on an aggregate or portfolio basis across all swaps under a master netting agreement. However, the Proposed Rules address the calculation of variation margin in a slightly different

[7] The "look up" table contains the following asset classes and percentages: credit swaps with a 0-2 year duration (1-3% of notional exposure), credit swaps with a 2-5 year duration (2-8% of notional exposure), credit swaps with greater than 5 years in duration (5-15% of notional exposure), commodity swaps (10-20% of notional exposure), equity swaps (10-20% of notional exposure), foreign exchange/currency (3-9% of notional exposure), interest rate swaps with a 0-2 year duration (0-2% of notional exposure), interest rate swaps with a 2-5 year duration (1-3% of notional exposure), interest rate swaps with greater than 5 years in duration (2-6% of notional exposure) and other swaps (10-20% of notional exposure).

manner. The Prudential Regulators' Proposal requires that the amount of variation margin that is required is equal to the difference between the cumulative mark-to-market value of the swaps and the value of all variation margin previously collected but not yet returned by the Swap Entity in connection with such swap. The CFTC Proposal simply states that the amount of variation margin that will be required to be collected by a Swap Entity from other Swap Entities or financial end-users must be calculated using a methodology specified in the relevant credit support arrangement between the parties. Such credit support arrangement must clearly identify the margin methodology for calculating variation margin requirements such that the CFTC and other regulators are able to calculate any such margin requirements independently.

Eligible Collateral

The Proposed Rules limit eligible forms of collateral to cash, U.S. Treasuries, and securities issued by certain "government-sponsored entities"[8]. Swap Entities must apply haircuts set out in the Proposed Rules when valuing eligible forms of collateral other than cash. Such haircuts are generally determined according to the maturity of the securities and its issuer. The limited forms of permitted collateral are substantially more restrictive than current market practice, and may be particularly burdensome with respect to transactions such as equity derivatives where it may be common for the underlying equity securities or other assets to serve as collateral.

The CFTC Proposal differs slightly and permits that non-financial entities may post non-traditional forms of collateral to satisfy variation margin requirements in accordance with its privately-negotiated agreements provided that such collateral has a value that can be determined from time to time.

Extraterritorial Reach of the Proposed Rules

The Proposed Rules will have an effect on swap market participants both inside and outside the U.S. The CFTC Proposal is silent on its potential extraterritorial application, although by its terms it would not distinguish between Swap Entities located in the U.S. or abroad. The Prudential Regulators' Proposal tries to limit certain potential extraterritorial consequences but on the whole also would extend the reach of the margin requirements to a U.S. Swap Entity's counterparty irrespective of whether such counterparty is located inside or outside the U.S.

The Prudential Regulators would apply margin requirements to any swap entered into by a Swap Entity with a U.S. domiciled counterparty regardless of whether such Swap Entity is a U.S. or non-U.S. entity. In addition, margin requirements would apply to swaps entered into between a U.S. or non-U.S. Swap Entity and a non-U.S. branch or office of a U.S. entity. The Prudential Regulators' Proposal would further capture swaps with a non-U.S. affiliate of a U.S. entity where the swap obligations of the non-U.S. affiliate are guaranteed by a U.S. domiciled person, branch or office of a U.S. entity.

The Prudential Regulators' Proposal does provide a carve out for "foreign non-cleared swaps or foreign non-cleared security based swaps" of a "foreign covered swap entity". Specifically, the margin requirements would not apply to any non-U.S.

[8] "Government -Sponsored Entities" include Fannie Mae, Freddie Mac, the Federal Home Loan Bank, and the Federal Agricultural Mortgage Corporation.

Swap Entity if its counterparty is a non-U.S. entity and is not a non-U.S. branch or office of a U.S. entity or a non-U.S. affiliate that has been guaranteed by a U.S. entity.

Conclusion

The Proposed Rules leave many open questions as to how the margin requirements will ultimately take shape. As Commissioner Scott O'Malia's dissenting vote on the CFTC Proposal indicates, the lack of complete harmonization between the Proposed Rules' treatments of non-financial end-users is going to be an issue of continued debate among market participants and regulators. A further question is where the SEC will come out on the same topic. As the CFTC has acknowledged, the full impact of the margin requirements will also depend on the corresponding capital requirements to be adopted by the CFTC and SEC for non-bank entities. There have been further political developments as well. On April 15, 2011, Rep. Michael G. Grimm (R-N.Y.) introduced the Business Risk Mitigation and Price Stabilization Act of 2011 (H.R. 1610), which would exempt commercial end-users from any margin requirements under Dodd-Frank. We will continue to monitor these developments and provide legislative and regulatory updates as these important rule proposals take shape.

If you wish to receive more information on the topics covered in this publication, you may contact your regular Shearman & Sterling contact person or any of the following:

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Appendix I: Margin Requirements Matrix

PROPOSED REQUIREMENT	COUNTERPARTY TYPE		
	SWAP ENTITY	FINANCIAL END-USER	NON-FINANCIAL END-USER
Initial Margin Threshold	Zero	· High-Risk: Zero · Low-Risk: Lesser of between \$15-\$45 million and 0.1 – 0.3 % of Tier 1/regulatory capital	· CFTC: No specific requirement; threshold per credit support arrangement · Prudential Regulators: credit exposure limit set by Swap Entity
Variation Margin Threshold	Zero	· High-Risk: Zero · Low-Risk: Lesser of between \$15-\$45 million and 0.1 – 0.3 % of Tier 1/regulatory capital	· CFTC: No specific requirement; threshold per credit support arrangement · Prudential Regulators: credit exposure limit set by Swap Entity
Frequency of Collection of Variation Margin	At least once per business day	At least once per business day	· CFTC: No specific requirement; per credit support arrangement · Prudential Regulators: At least once per week
Minimum Transfer Amount	\$100,000	\$100,000	· CFTC: No specific requirement; Amount per credit support arrangement · Prudential Regulators: If credit limit exceeded - \$100,000
Segregation of Initial Margin	Independent (non-affiliated) third-party custodian	Not mandatory but can request	Not mandatory but can request