

## Prudential Regulators and CFTC Re-Propose Margin Requirements for Non-Cleared Swaps

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Federal banking regulators (the Prudential Regulators)<sup>1</sup> have re-proposed regulations to require certain dealers and major participants in the swap and security-based swap markets to collect initial and variation margin for non-cleared swaps (the 2014 Proposal).<sup>2</sup> In April 2011, the Prudential Regulators first issued proposed rules addressing non-cleared swaps margin (the 2011 Proposal).<sup>3</sup> Following the 2011 Proposal, the Basel Committee on Banking Supervision and the International Organization of Securities Commissions released a global framework for margin requirements on non-centrally cleared derivatives (the International Framework).<sup>4</sup> As a result, the Prudential Regulators released the 2014 Proposal to incorporate the International Framework and to address comments received on the 2011 Proposal. The CFTC this week voted to issue a similar re-proposal.

The 2014 Proposal would apply to all “swap entities” that are regulated by a Prudential Regulator (CSEs).<sup>5</sup>

The 2014 Proposal makes several significant changes to the 2011 Proposal by:

1. requiring CSEs to post margin in addition to collecting margin;
2. restricting the acceptable collateral for variation margin to cash while expanding the collateral that can be used as initial margin; and
3. adopting a substituted compliance approach that would allow certain CSEs to comply with a foreign regulatory framework in lieu of the Prudential Regulators’ requirements.

The 2014 Proposal retains many of the requirements from the earlier proposal, and continues to require significantly larger amounts of margin than for cleared contracts. This client alert answers some of the basic questions about the re-proposal, summa-

<sup>1</sup> The Prudential Regulators are the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Farm Credit Administration (FCA) and the Federal Housing Finance Agency (FHFA).

<sup>2</sup> In this client alert, the term “swaps” refers both to swaps and securities-based swaps.

<sup>3</sup> See Margin and Capital Requirements for Covered Swap Entities, Proposed Rule, 76 Fed. Reg. 27564 (May 11, 2011). In 2011, the Commodity Futures Trading Commission (CFTC) also released proposed non-cleared swaps margin requirements for swap dealers and major swap participants, and the Securities and Exchange Commission (SEC) proposed non-cleared swaps margin requirements for security-based swap dealers and major security-based swap participants. See CFTC Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, Notice of Proposed Rulemaking, 76 Fed. Reg. 23,732 (Apr. 28, 2011); Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, Proposed Rule, 77 Fed. Reg. 70213 (Nov. 23, 2012).

<sup>4</sup> See BCBS and IOSCO “Consultative Document — Margin requirements for non-centrally cleared derivatives” (July 2012), available at <http://www.bis.org/publ/bcbs226.pdf>; “Second consultative document — Margin requirements for non-centrally cleared derivatives” (February 2013), available at <http://www.bis.org/publ/bcbs242.pdf>.

<sup>5</sup> The term “swap entity” would mean a securities-based swap dealer, major securities-based participant, swap dealer or major swap participant.

rizes the proposed margin counterparty categories and gives an overview of how margin calculations would be made. Attached is a chart of the significant proposed requirements depending on counterparty category.

### A. Basic Questions About Uncleared Margin

1. What will be considered a “non-cleared swap”? The 2014 Proposal would apply to swaps that are not cleared by a CFTC-registered derivatives clearing organization (DCO) or a clearing agency registered with the SEC. Margin would not be required for physically settled foreign exchange forwards or swaps<sup>6</sup> or foreign swaps (which would include swaps where neither the counterparty nor the guarantor is a U.S. entity) of foreign CSEs.
2. Will the kind of counterparty matter? Yes. Margin requirements would vary based on whether the counterparty is a swap entity, financial end user<sup>7</sup> with material swaps exposure, financial end user without material swaps exposure or another kind of counterparty.
3. How will initial margin be calculated? Like in the 2011 Proposal, a CSE will be able to use a standardized table compiled by the Prudential Regulators. Alternatively, a CSE can use an initial margin model approved by the relevant Prudential Regulator.
4. What is an initial margin threshold? The 2014 Proposal would permit a CSE to adopt a threshold amount of up to \$65 million, below which it would not need to collect or post initial margin on swaps with swap entities and financial end users with material swaps exposures.
5. Is there a threshold for variation margin? The 2014 Proposal would *not* permit a CSE to adopt a threshold amount below which it would not need to collect or post variation margin on swaps with swap entities and financial end users (regardless of whether the financial end user has material swaps exposure).
6. What kinds of collateral can be posted? For initial margin, eligible collateral would be cash, debt securities issued or guaranteed by the U.S. Department of the Treasury or another U.S. government agency, the Bank for International Settlements, the International Monetary Fund, the European Central Bank, multilateral development banks, certain U.S. government-sponsored enterprises’ debt securities, certain foreign government debt securities, certain corporate debt securities, certain listed equities and gold. Noncash collateral and cash collateral that is not USD or the currency in which payment obligations under the swap are required to be settled would be subject to certain specified discounts (commonly known as “haircuts”). For variation margin, eligible collateral would be cash only; cash must be denominated in USD or in the currency in which payment obligations under the swap are required to be settled.
7. What about third-party custodians? Like the 2011 Proposal, the 2014 Proposal would require that any collateral (other than variation margin) that a CSE posts to its counterparty (including collateral not required by the 2014 Proposal) would be required to be segregated at one or more custodians that are not affiliates of the CSE or the counterparty (a Third-Party Custodian). Furthermore, a CSE would be required to place the initial margin

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6 In 2012, the Secretary of the Treasury made a determination that physically settled foreign exchange forwards and swaps are not to be considered swaps under the Dodd-Frank Act. See Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, 77 Fed. Reg. 69694 (Nov. 20, 2012). Although margin would not be required for these kinds of swaps, foreign exchange forwards and foreign exchange swaps exposure would be relevant for determining material swaps exposure.

7 See below for a list of entities that would be financial end users.

it collects from a swap entity or a financial end user with material swaps exposure at a Third-Party Custodian.<sup>8</sup> A CSE would not be required to segregate the initial margin it collects from financial end users without material swaps exposures or Other Counterparties (as defined below). There would be restrictions on rehypothecation, although substitutions and reinvestments in eligible collateral would be permitted. There would be no segregation requirements for variation margin.

## **B. Proposed Margin Counterparty Categories**

### **1. Counterparty Category 1: CSE to Another Swap Entity**

For swaps with other swap entities, CSEs would be required to post and collect initial margin at the time they enter into a swap and to post and collect variation margin on a daily basis.

### **2. Counterparty Category 2: CSE to Financial End User With Material Swaps Exposure**

The 2014 Proposal would define the term financial end user to include: bank holding companies, savings and loan holding companies, nonbank financial institutions supervised by the Board of Governors of the Federal Reserve System, depository institutions, foreign banks, state-licensed or registered credit or lending entities, broker-dealers, registered investment companies, business development companies, private funds, securitization vehicles, commodity pools, commodity pool operators, employee benefit plans, insurance companies, cooperatives that are financial institutions, similar foreign entities and any other entity that a Prudential Regulator determines should be treated as a financial end user.<sup>9</sup>

A financial end user would have material swaps exposure when the entity and its affiliates 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 that exceeds \$3 billion.

A CSE would be required to post initial margin and daily variation margin to, and collect initial margin and daily variation margin from, financial end users with material swaps exposures.

### **3. Counterparty Category 3: CSE to Other Counterparty**

“Other Counterparties” are counterparties that are not CSEs or financial end users with material swaps exposure. Other Counterparties include commercial end users that generally engage in swaps to hedge commercial risk, sovereigns (which would have been financial end users in the 2011 Proposal), multilateral development banks and financial end users without material swaps exposure.

When transacting with an Other Counterparty, the 2014 Proposal would only require a CSE to collect initial margin at such times and in such forms and such amounts that the CSE determines appropriately addresses the credit risk posed by the counterparty and the risk of the swap. This could result in the CSE determining not to collect any initial margin from an Other Counterparty. There would be no requirement that a CSE post initial margin to an Other Counterparty.

The Prudential Regulators consider financial end users without material swaps exposure to be Other Counterparties for purposes of initial margin because they expect that in most instances, a financial end user without material swaps exposure would have an initial margin requirement that is signifi-

<sup>8</sup> A CSE would only be required to segregate the required minimum amount of initial margin that it collects from a swap entity or a financial end user with a material swaps exposure.

<sup>9</sup> This list of entities included within the definition of a financial end user was intended to eliminate potential uncertainties with the 2011 Proposal definition, which would have included persons predominantly 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.

cantly below the proposed \$65 million threshold amount. A CSE would, however, be required to collect and post variation margin on swaps with financial end users without material swaps exposures. Thus, variation margin would be required for swaps with all financial end users.

When transacting with an Other Counterparty other than an Other Counterparty that is a financial end user without material swaps exposure, the 2014 Proposal would not require a CSE to post variation margin and would only require a CSE to collect variation margin at such times and in such forms and in such amounts that the CSE determines appropriately addresses the credit risk posed by the counterparty and the risk of the swap.

### C. Proposed Margin Calculations

#### 1. Initial Margin Calculation

The Prudential Regulators propose two alternative methods for calculating initial margin: (1) a standardized margin schedule, expressed as a percentage of the notional amount of the swap that allows for certain types of netting and offset exposure; or (2) an approved internal initial margin model.

There would be extensive requirements for initial margin models, such as basing potential future exposure on a 99 percent confidence interval for a 10-day period (compared to the current practice of using a one- to five-day period for cleared swaps) and calibrating the initial margin to a period of financial stress. Initial margin models could consider portfolio offsets for swaps within the same asset class — agricultural commodities, energy commodities, metal commodities, other commodities, credit, equity or foreign exchange/interest rate — that are governed by the same netting agreement (*e.g.*, an ISDA). Internal margin models would need the approval of the relevant Prudential Regulator. Initial margin requirements would not apply to Treasury-exempted foreign exchange (FX) forwards and swaps or to the fixed physically settled FX component of cross-currency swaps.

The Prudential Regulators stressed that the decision to use one method over the other should be based on fundamental considerations apart from which method produces the most favorable margin results. The Prudential Regulators noted that they generally would frown upon “cherry picking” between the standardized approach and internal model-based margins, either across different types of swaps or for a particular counterparty.

#### 2. Variation Margin Calculation

Under the re-proposal, variation margin would be a payment by one party to its counterparty of the change in value of the obligations under one or more swaps between the parties since the last such payment. The 2014 Proposal would require a CSE to collect or post variation margin on all swaps with a swap entity or financial end user (regardless of whether the financial end user has a material swaps exposure) daily. The 2014 Proposal would not permit a CSE to adopt a threshold amount for posting or collecting variation margin on swaps with swap entities or financial end users. A CSE could calculate variation margin on an aggregate net basis for swaps governed by a master netting agreement that meets specified conditions.<sup>10</sup>

### D. Other Margin Requirements

A CSE would not be required to post or collect any margin from any counterparty under a minimum transfer amount of \$650,000. A CSE also would be required to execute trading documentation that grants the CSE the contractual right to collect margin in amounts and under the circumstances neces-

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<sup>10</sup> Swaps entered into before the applicable compliance date that are subject to the master netting agreement would need to be included in the aggregate calculation.

sary to meet the 2014 Proposal's requirements, details the specifications for determining the value of each swap for variation margin purposes and provides valuation dispute procedures.

### **E. Phase-In and Comments**

Initial margin requirements would be phased in over a four-year period based on volume of swap activity. Beginning on December 1, 2015, the requirements would only apply to a CSE where both the CSE (combined with its affiliates) and the CSE's counterparty (combined with its affiliates) have an aggregate notional amount of covered swaps exceeding \$4 trillion, declining to \$3 trillion in 2016, \$2 trillion in 2017 and \$1 trillion in 2018 (using the aggregate notional amount for the preceding June, July and August of the relevant year) until December 1, 2019, when the initial margin requirements would apply to any CSE. Variation margin requirements would have no phase-in and would go into effect on December 1, 2015.

The comment period for the 2014 Proposal will close 60 days after the proposed rule is published in the Federal Register.

### **F. CFTC and SEC Re-Proposals**

On September 17, 2014, the CFTC voted to re-propose its own non-cleared margin requirements. The CFTC requirements would apply to swap dealers and major swap participants that are not CSEs (*i.e.*, swap dealers and major swap participants that are not subject to regulation by the Prudential Regulators). The CFTC said its re-proposal tracks the Prudential Regulators' re-proposal and phase-in approach in most respects. One difference between the two proposals is that the CFTC asks commenters to weigh in on three potential approaches to how its non-cleared margin rules would apply in a cross-border context, while the Prudential Regulators' 2014 Proposal provides only one approach to applying the Prudential Regulators' rules in a cross-border context.

The SEC also is expected to re-propose its non-cleared margin proposal but has not yet done so.

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## Prudential Regulators' Proposed Margin Requirements for Non-Cleared Swaps

Counterparty Type	Initial Margin	Calculating Initial Margin	Initial Margin Thresholds	Acceptable Initial Margin Collateral	Initial Margin Segregation	Variation Margin	Acceptable Variation Margin Collateral
Swap Entity	CSE must collect from, and post to, at least the amount of initial margin required under the 2014 Proposal at least daily	CSE may use a standardized margin schedule or an internal margin model approved by the relevant Prudential Regulator	CSE may adopt a maximum initial margin threshold amount of \$65 million, below which it need not post or collect	Cash, gold, certain government bonds, corporate bonds and equities. Collateral is subject to minimum haircuts	All initial margin posted by CSE and all initial margin collected by CSE in accordance with the 2014 Proposal must be segregated at a Third-Party Custodian	CSE must collect from and post to the counterparty at least once per business day	Only USD or the currency in which payment obligations under the swap are required to be settled
Financial End User With Material Swaps Exposure	Same as above	Same as above	Same as above	Same as above	Same as above	Same as above	Same as above
Financial End User Without Material Swaps Exposure	CSE not required to post. CSE not required to collect except at times and in forms and amounts that CSE determines appropriately address counterparty credit risk and risk of the swap	Calculations not applicable, instead determined by CSE	Any thresholds determined by CSE	Not limited, instead determined by CSE	Initial margin posted by CSE must be segregated at a Third-Party Custodian. Initial margin collected by CSE not required to be segregated at a Third-Party Custodian	Same as above	Not limited, instead determined by CSE
Other Counterparty (other than financial end users without material swaps exposures)	Same as above	Same as above	Same as above	Same as above	Same as above	CSE not required to post. CSE not required to collect, except at times and in forms and amounts that CSE determines appropriately address counterparty credit risk and risk of the swap	Same as above