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E-ALERT | Dodd-Frank Act

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CFTC AND PRUDENTIAL REGULATORS PROPOSE MARGIN REQUIREMENTS FOR UNCLEARED SWAPS

The Commodity Futures Trading Commission ("CFTC") and banking regulators voted recently to propose margin requirements for uncleared swaps under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). The rules issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Farm Credit Administration, and the Federal Housing Finance Agency (collectively, the "prudential regulators") will apply to swap dealers and major swap participants (collectively, "swap entities") that are banks regulated by these agencies. The rules issued by the CFTC will apply to non-bank swap entities.

The proposed rules issued by the CFTC and the prudential regulators are similar in many respects, but also have some differences. Both sets of proposed rules require swap entities to collect initial and variation margin from certain counterparties and, in some circumstances, to post initial and variation margin themselves. Both sets of proposed rules also impose fewer margin requirements on non-financial end users that enter into swaps to hedge or mitigate commercial risk. Under the CFTC's proposed rules, non-financial end users would not be required to post margin on uncleared swaps, while non-bank swap entities would be required to post margin to counterparties. Swap entities would still be required to enter into credit support arrangements with non-financial end-user counterparties under the CFTC's proposed rules. The prudential regulators would, however, require bank swap entities to collect margin from both financial and non-financial end users, if certain permissible thresholds of credit exposure were exceeded. The prudential regulators further proposed to require bank swap entities to meet existing bank capital requirements for derivatives positions. The CFTC is expected to issue its proposed capital requirements for non-bank swap entities later this month.[1]

Comments on the prudential regulators' proposed margin requirements are due June 24, 2011. Comments on the CFTC's proposed margin requirements will also be due in late June (60 days after the proposed rules are published in the *Federal Register*, which publication has not yet occurred).

DODD-FRANK IMPOSES MARGIN REQUIREMENTS ON SWAP ENTITIES

Title VII of Dodd-Frank sets forth a comprehensive new regulatory framework for derivatives. As part of this framework, Dodd-Frank establishes the new categories of swap dealers and major swap participants, to which the margin rules refer as "swap entities," that must register with the CFTC and comply with certain regulatory requirements. Among these requirements are capital and margin requirements. Specifically, Dodd-Frank requires the prudential regulators for bank swap entities and the CFTC for non-bank swap entities to set both initial and variation margin requirements on all swaps that are not cleared by a registered derivatives clearing organization ("DCO"). Dodd-Frank

[1] Dodd-Frank requires the Securities and Exchange Commission ("SEC") to set capital and margin requirements for security-based swap dealers and major security-based swap participants, but the SEC has not yet proposed these rules.

contemplates that initial and variation margin will offset the greater risk to the swap entities and the financial system arising from uncleared swaps, and directs regulators to set margin that will both ensure the safety and soundness of the swap entities and be appropriate for the risk associated with uncleared swaps.

THE PROPOSED MARGIN RULES

What Types of Counterparties Require Margin?

Both the CFTC and the prudential regulators proposed a risk-based approach to margin requirements that distinguishes between different types of counterparties. As described below, the proposed margin requirements depend on whether the swap entity enters into a swap with another swap dealer or major swap participant, a financial entity, or a non-financial entity. The requirements further distinguish between high-risk and low-risk financial entities.

Swaps with Swap Dealers or Major Swap Participants

Concluding that transactions between two swap entities pose greater risk to the financial system, both the CFTC and the prudential regulators proposed to require swap entities to collect both initial and variation margin for these swaps. The proposed rules further require swap entities to maintain initial and variation margin at certain amounts. Although zero thresholds would be required for both initial and variation margin, there would be a proposed "minimum transfer amount" of $100,000 below which the actual transfer of funds would not be required. Because each swap dealer would be required to collect margin from the other, the proposed rules effectively require two-way posting of margin for these transactions.

Swaps with Financial Entities

Both the CFTC and the prudential regulators proposed to require swap entities to collect both initial and variation margin from financial entities. Although zero thresholds would be required for some financial entities, the regulators proposed permissible levels of exposure to certain financial entities deemed to pose less risk to the financial system. Finally, the proposed rules contemplate that swap entities would collect variation margin from financial entities, but would not pay variation margin to them. The agencies requested comment on whether the proposed one-way posting of margin is appropriate.[2]

Financial Entity. The proposed rules define "financial entity" to mean a counterparty that is not a swap dealer or major swap participant, but is one of the following:

- A commodity pool as defined in Section 1a(5) of the Commodity Exchange Act;
- A private fund as defined in Section 202(a) of the Investment Advisors Act of 1940;
- An employee benefit plan as defined in paragraphs (3) and (32) of Section 3 of the Employee Retirement Income and Security Act of 1974;
- A person 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 of 1956;

[2] The Farm Credit Administration and the Federal Housing Finance Agency proposed additional regulations for entities they regulate. Those agencies will require entities subject to their jurisdiction to collect initial margin and variation margin from their counterparties when they enter into an uncleared swaps with a swap entity.

- A person that would be a commodity pool or a private fund, as defined above, if it were organized under the laws of the United States or any U.S. state;
- The government of any foreign country or a political subdivision, agency, or instrumentality of a foreign country; or
- Any other person that either a prudential regulator or the CFTC may designate, as applicable to swap entities regulated by that regulator.

With a few modifications, this definition generally tracks the definition of financial entity used for purposes of the end-user clearing exception that Dodd-Frank adds to Section 2(h)(7)(C) of the Commodity Exchange Act. Although they have not proposed to exclude small financial institutions from the definition of "financial entity," both the CFTC and the prudential regulators requested comment on whether small financial institutions should be treated like non-financial end users for purposes of the margin rules.

Thresholds for "Low Risk" Financial Entities. Both the CFTC and the prudential regulators proposed to permit certain levels of exposure to certain financial entities, which the prudential regulators call "low-risk financial end users." Although neither the CFTC nor the prudential regulators have yet proposed specific thresholds, they suggested that the threshold might fall within the range of $15-$45 million or 0.1-0.3% of the swap entity's tier-one regulatory capital, whichever is less. The agencies requested comment on these amounts.

Definition of "Low Risk" Financial Entities. Under both sets of proposed rules, these initial and variation margin thresholds would apply to financial entities that:

- Are subject to capital requirements established by a prudential regulator or a state insurance regulator;
- Predominantly use swaps to hedge or mitigate business risks; and
- Do not have "significant swaps exposure," which would be defined as either $2.5 billion in daily average aggregate uncollateralized outward exposure or $4 billion in daily average aggregate uncollateralized outward exposure plus daily average aggregate potential outward exposure. "Significant swaps exposure" would be calculated in a manner similar to "substantial position" for purposes of defining a major swap participant.

Swap entities will not be permitted to have uncollateralized credit exposure to financial entities that do not fall within this definition of "low risk."

Swaps with Non-financial Entities

Concluding that non-financial entities using swaps to hedge commercial risk pose less risk to the financial system, the CFTC and the prudential regulators proposed to require less margin from these counterparties. The CFTC's proposed rules do not impose either initial or variation margin. Rather, the CFTC proposed to require that swap entities enter into credit support arrangements that would help ensure the safety and soundness of the swap entity by providing clarity as to its rights and obligations. The parties would remain free to set their own initial or variation margin requirements.

By contrast, the prudential regulators proposed to require swap entities to collect initial and variation margin from non-financial entities. The prudential regulators would, however, permit swap entities to adopt appropriate thresholds below which they would not collect initial or variation margin from non-financial end users. Unlike the thresholds for "low risk" financial entities, however, the maximum thresholds for non-financial end users are not specified in the proposed rules. When these thresholds are exceeded, swap entities would be required to collect variation margin less frequently (*i.e.*, no less than once per week, instead of the daily collection requirement for other swap entities and financial entities). As for financial entities that engage in swaps with a non-financial entity, the proposed rules issued by the prudential regulators contemplate one-way posting of margin for such trades by the non-financial entity.

How Is Margin Calculated?

Initial Margin

Models. Both the CFTC and prudential regulators proposed to permit swap entities to use models to calculate initial margin. The proposed CFTC rules would require the model to be:

- Currently in use for margining cleared swaps by a DCO;
- Currently in use for margining uncleared swaps by an entity subject to regular assessment by a prudential regulator; or
- Available for licensing to any market participant by a vendor.

By contrast, the prudential regulators would permit swap entities subject to their jurisdiction to use an internal initial margin model that has been reviewed, and approved, by the relevant prudential regulator. The prudential regulators would not permit swap entities to use DCO models or models licensed to market participants. The CFTC expressed that internal models were appropriate for bank swap entities because, among other things, prudential regulators have the resources to review individual proprietary models.

Both sets of proposed rules require the model to set margin to cover at least 99% of price changes by product and by portfolio over at least a 10-day liquidation time horizon, compared with the three-to-five day horizon commonly used by derivatives central clearing parties. The proposed rules further require the model to be calibrated to a period of financial stress.

Alternatives. If the swap entity does not use an appropriate model, then the proposed rules provide alternative methods of calculating initial margin. The CFTC's proposed rules would require swap entities to identify the margin that a DCO would require for a similar cleared contract. The proposed rules would then require swap entities to multiply the DCO margin by a specified factor accounting for a longer anticipated liquidation time horizon and additional risks. For cleared swaps, the CFTC proposed a multiplier of 2.0. For cleared futures, the CFTC proposed a multiplier of 4.4.

Absent use of a model, the prudential regulators proposed to require bank swap entities to use a standardized "lookup" table that specifies the minimum initial margin that must be collected as a percentage of the swap notional value. The percentage would vary depending on the broad asset class of the swap.

Variation Margin

Both sets of proposed rules require swap entities to enter into credit support arrangements documenting, among other things, the methods, procedures, rules, and inputs for determining the value of each swap for purposes of calculating variation margin payments. Both sets of rules further require daily mark-to-market valuation of a swap entered into with another swap entity or with a financial entity. As noted above, the rules proposed by the prudential regulators require less frequent valuation of swaps entered into with non-financial entities.

What Collateral May Be Posted as Margin?

Initial Margin

Swap entities generally may accept the following forms of initial margin, which the agencies have determined to have deep and liquid markets:

- Immediately available cash funds denominated in U.S. dollars or the currency in which payment obligations under the swap are required to be settled;
- Direct obligations of, or obligations fully guaranteed as to principal and interest by, the United States or an agency of the United States;
- Senior debt obligations of the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, or the Federal Agricultural Mortgage Corporation; or
- Insured obligations of a Farm Credit System bank.

Under the CFTC's proposed rules, if a swap entity and a non-financial entity agree to post margin, then the swap entity may collect other forms of collateral, so long as the value of the asset is "reasonably ascertainable." Under the rules proposed by the prudential regulators, however, only the forms of collateral listed above are permitted. Both sets of proposed rules incorporate haircuts for non-cash collateral (including U.S. Treasury securities).

Variation Margin

Under the CFTC's proposed rules, variation margin payments must be in cash or U.S. Treasury securities. Under the rules proposed by the prudential regulators, however, any of the assets listed above may be used for variation margin except for insured obligations of Farm Credit System banks. Both sets of rules include a proposed table of haircuts for non-cash collateral (including U.S. Treasury securities).

Where May Margin Be Held?

Under both sets of proposed rules, swap entities would be required to segregate initial margin with an independent, third-party custodian for all uncleared swaps for which their counterparty is another swap entity. Under the proposed rules, the custodian must be subject to the same insolvency regime as the swap entity. The proposed rules further require the swap entity to specify in the custodial agreement that the custodian may not rehypothecate margin assets or reinvest them in assets that are not permitted forms of margin. Finally, a swap entity could not post margin from a counterparty as margin for another swap, security-based swap, futures contract, security, or other product subject to margin. The independent custodian requirement would not apply to variation margin.

The CFTC's proposed rules require swap entities subject to its jurisdiction to offer counterparties the opportunity to segregate assets with an independent, third-party custodian.

THE PRUDENTIAL REGULATORS' PROPOSED CAPITAL REQUIREMENTS

Dodd-Frank also requires regulators to set capital requirements for swap entities. The prudential regulators proposed to require bank swap entities to comply with existing capital requirements that those regulators think ensure bank swap entities' safety and soundness. Dodd-Frank charges the CFTC with setting capital requirements for non-bank swap entities. The CFTC has not yet proposed capital rules, which are expected to be released later this month.

The prudential regulators' proposed capital and margin rules for bank swap entities are available here. The CFTC's proposed margin rules for non-bank swap entities are available here.

If you have any questions about the proposed new margin requirements for uncleared swaps or their impact on your business, or if you would like to submit comments on the proposed rules, please contact the following members of our firm:

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