



## Investment Management, Trading & Markets ADVISORY ■

**NOVEMBER 18, 2015**

### Prudential Regulators Adopt Final Rule for Margin on Non-cleared Swaps and Non-cleared Security-Based Swaps

On October 22, 2015, the Board of Directors of the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Farm Credit Administration and the Federal Housing Finance Agency (collectively, the “agencies”) jointly approved a final rule<sup>1</sup> (the “Rule”) to establish margin and capital requirements for swaps and security-based swaps that are not cleared through a registered clearinghouse. The Rule applies to any “swap entity” (i.e., any swap dealer or major swap participant registered with the Commodity Futures Trading Commission (CFTC) or security-based swap dealer or major security-based swap participant registered with the Securities and Exchange Commission (SEC)) that is also subject to the jurisdiction of one of the agencies (“covered swap entities”). All of a covered swap entity’s non-cleared swaps and non-cleared security-based swaps are subject to the Rule, even if the covered swap entity is registered only with the CFTC or only with the SEC. Swap entities that are not covered swap entities will be subject to the CFTC’s and/or SEC’s margin rules, which have not yet been finalized.

Sections 731 and 764 of the Dodd-Frank Wall Street Reform and Consumer Protection Act require the agencies to adopt joint rules to establish capital requirements and initial and variation margin requirements for covered swap entities on all non-cleared swaps and all non-cleared security-based swaps in light of the perceived risk associated with those swaps. Margin requirements under the Rule largely follow the policy framework issued by the Bank for International Settlements’ Basel Committee on Banking Supervision and the International Organization of Securities Commissioners, released in September 2013 and amended in March 2015.<sup>2</sup>

<sup>1</sup> [Margin and Capital Requirements for Covered Swap Entities](#), Department of the Treasury Office of the Comptroller of the Currency, 12 CFR Part 45; Board of Governors of the Federal Reserve System, 12 CFR Part 237; Federal Deposit Insurance Corporation, 12 CFR Part 349; Farm Credit Administration, 12 CFR Part 624; Federal Housing Finance Agency, 12 CFR Part 1221.

<sup>2</sup> See Basel Committee on Banking Supervision and International Organization of Securities Commissioners “Margin Requirements for Non-centrally Cleared Derivatives” (September 2013), available at <http://www.bis.org/publ/bcbs261.pdf>. The September 2013 publication was amended in March 2015 to delay the implementation date. The amended framework is available at <http://www.bis.org/bcbs/publ/d317.pdf>.

The Rule, which was developed in consultation with the CFTC and SEC, becomes effective on April 1, 2016. Compliance with the Rule is required on a phased-in schedule that depends on the aggregate notional amount of non-cleared swaps, non-cleared security-based swaps, foreign exchange forwards and foreign exchange swaps for both the covered swap entity (including its affiliates) and the counterparty (including its affiliates). The phase-in period runs from September 1, 2016, through September 1, 2020, for initial margin and from September 1, 2016, through March 1, 2017, for variation margin.

## Margin Requirements

**General.** The margin requirements under the Rule establish the minimum amount of initial and variation margin that a covered swap entity must exchange with its counterparties. Using a risk-based approach, the Rule distinguishes among four primary categories of counterparties, with the minimum initial and variation margin requirements depending upon the counterparty's category: (1) swap entities (whether or not they are covered swap entities); (2) financial end users with a material swaps exposure; (3) financial end users that do not have a material swaps exposure; and (4) all other counterparties (including non-financial end users, sovereigns and multilateral development banks). "Financial end users" include broker-dealers, investment advisors, commodity pools, private funds, credit unions, pooled investment vehicles and other entities that are not swap entities. An entity has a material swaps exposure if the average daily aggregate notional amount of its non-cleared swaps, non-cleared security-based swaps, foreign exchange forwards and foreign exchange swaps over a specified three-month period exceeds \$8 billion.

**Initial margin.** A covered swap entity must collect initial margin from any counterparty that is a swap entity or a financial end user with material swaps exposure. In addition, a covered swap entity must post initial margin to the same categories of counterparties. The Rule permits a covered swap entity to determine the initial margin amount by using either a standardized margin schedule specified in the Rule or an internal margin model satisfying the Rule's criteria and approved by the agency with supervisory authority over the covered swap entity. For both approaches, the calculations take into account netting of transactions that are subject to an eligible master netting agreement. The initial margin amount determined under the standardized schedule or internal model is then reduced by a threshold of up to \$50 million. The threshold is shared across all swaps and security-based swaps between the covered swap entity and its affiliates on the one hand and the counterparty and its affiliates on the other. Initial margin may be provided in a number of forms specified in the Rule, including cash (U.S. dollars or other major currency or the settlement currency for the swap or security-based swap), debt securities that are issued or guaranteed by U.S. government agencies, certain non-U.S. government debt securities, certain corporate debt securities, gold and other high quality liquid assets. Most forms of collateral are subject to haircuts. Segregation requirements apply to initial margin.

**Variation margin.** The variation margin requirement applies to non-cleared swaps and non-cleared security-based swaps between a covered swap entity and any swap entity or financial end user, regardless of whether the financial end user has a material swaps exposure. Variation margin must be calculated and exchanged on a daily basis. The amount to be exchanged must be at least equal to the increase or decrease in the value of the swap or security-based swap since the parties' previous exchange of variation margin. Variation margin

posted by a swap entity must be in the form of cash (U.S. dollars or other major currency, or the settlement currency for the swap or security-based swap). Financial end users may post variation margin in any form that would be acceptable as initial margin. Haircuts apply to most types of margin.

**Swaps and security-based swaps not subject to specific margin requirements.** The amount, form and frequency of initial margin and variation margin for non-cleared swaps and non-cleared security-based swaps not covered by the requirements outlined above may be determined by the covered swap entity based on its assessment of the counterparty's creditworthiness and the risks associated with those transactions. Margin requirements do not apply to swaps and security-based swaps that are not cleared on the basis of either the end-user exception or the exception for treasury affiliates acting as agents for an end user.

**Transactions with affiliates of covered swap entities.** Swaps and security-based swaps between a covered swap entity and its affiliates are generally not exempt from the requirement to post and collect initial and variation margin, but some of the requirements are relaxed through certain exclusions, thresholds and calculation methodologies and holding period mechanics in the covered swap entity's determination of margin.

**Cross-border transactions.** The Rule specifies when a non-cleared swap or non-cleared security-based swap is subject to the rules of a foreign jurisdiction rather than the Rule. Generally, if the parties to the transaction have no U.S. connection, as more specifically described in the Rule, the Rule's margin requirements are not applicable. In addition, the Rule may not apply if a relevant foreign regulator's margin requirements are sufficiently comparable to those contained in the Rule.

## Regulatory Capital

Dodd-Frank also requires the agencies to issue joint rules on capital requirements for covered swap entities' swap and security-based swap activity. Because derivatives activities are already captured under the individual agencies' risk-based capital rules, most of which are based on the Basel III framework, the agencies determined that no additional rulemaking was necessary to protect covered swap entities from the perceived risks arising in the non-cleared swap and security-based swap context.

## Interim Final Rule for Swaps and Security-Based Swaps Subject to the End-User Exception

The agencies adopted an interim final rule to address the exemption from the margin requirements for swaps and security-based swaps that are not cleared on the basis of either the end-user exception or the exception for treasury affiliates acting as agent for an end user. The interim final rule,<sup>3</sup> which implements the statutory exemption established under the Terrorism Risk Insurance Program Reauthorization Act of 2015, is effective April 1, 2016. Comments on the interim final rule must be submitted on or before January 31, 2016.

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<sup>3</sup> [Margin and Capital Requirements for Covered Swap Entities](#), Department of the Treasury Office of the Comptroller of the Currency, 12 CFR Part 45; Board of Governors of the Federal Reserve System, 12 CFR Part 237; Federal Deposit Insurance Corporation, 12 CFR Part 349; Farm Credit Administration, 12 CFR Part 624; Federal Housing Finance Agency, 12 CFR Part 1221.

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