RICHARDS KIBBE & ORBE LLP

Client Alert

February 22, 2016

"In the long history of Dodd-Frank Act regulatory roll-out, implementation of uncleared swap margin rules will be among the biggest changes affecting the economic returns on financial end-users' swaps."

Prepare for Uncleared Swaps Margining: What a Financial End-User Needs to Know

By Julia Lu and John A. Clark

Six years following the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act, regulations governing margin delivery requirements for uncleared swaps will become effective starting September 2016. Directly regulating swap dealers like banks and brokerage firms, the rules also significantly affect over-the-counter derivatives contracts of private funds and other buy-side counterparties who trade with regulated entities. Financial end-users should begin preparing well in advance of upcoming effective dates. Adapting to a mandatory margin delivery environment may be time and labor intensive, as many firms will have to amend their swap trading agreements, revisit collateral management protocols and source liquid assets for collateral delivery. To further acquaint fund managers and their counsels to the uncleared swap margin requirements, we answer some important, high-level questions below.

WHAT REGULATIONS GOVERN MARGIN FOR UNCLEARED SWAPS?

As of now, the Federal Reserve and several other federal banking regulators (collectively known as "the Prudential Regulators") and the Commodity Futures Trading Commission (CFTC) have published two separate sets of final rules governing uncleared swap margin requirements. Corresponding rules by the Securities and Exchange Commission (SEC), which has primary regulatory authority over security-based swaps, remain in proposed form only. In this note, we only address the Prudential Regulators' or CFTC's final margin rules, and not any margin requirements that may become applicable to SEC-regulated transactions or entities.

Both the Prudential Regulators' and CFTC's rules require regulated swap entities to meet mandatory margin delivery, collection, holding and segregation requirements for uncleared swaps contracts executed with "financial end-users,"[1] including, among others, private funds, commodity pools and employee benefit plans. The mandatory terms of these contracts, in turn, will require financial end-user counterparties to agree to collateral management practices that comply with the regulatory stipulations. In this note, we will refer to swap entities, whether regulated by the Prudential Regulators or the CFTC, as "swap dealers."

1. In this note, we only discuss margin rules as applicable to financial end-users, and not the implication to non-financial end-users.

New York
Washington
London
WWW.RKOLLP.COM

WHOSE RULES APPLY?

Different sets of U.S. margin regulations apply to different regulated swap dealers. If an end-user enters into an uncleared swap with a U.S. swap dealer, either the Prudential Regulators' or CFTC's rules apply, depending on whether the swap dealer is primarily regulated by a Prudential Regulator or by the CFTC. For example, U.S. banks and bank holding companies are subject to the jurisdiction of the Federal Reserve, whereas a U.S. non-bank swap dealer (*e.g.*, a non-depository subsidiary of a financial holding company) is subject to the jurisdiction of the CFTC. If an end-user trades with both bank and non-bank swap entities, it should be cognizant that technically two sets of rules govern its swap contracts. Fortunately, as applicable to most financial end-users, the rules largely mirror one another in practical respects.

The cross border application of the Prudential Regulators' and CFTC's margin rules is more complicated.[2] Generally speaking, the extent to which U.S. margin rules apply turns on the U.S. person status, or the link to a U.S. person, of both the swap dealer and the end-user counterparty. If the end-user is a U.S. person, and the swap dealer is, or is guaranteed by, a U.S. person, then the U.S. margin rules fully apply. For these purposes, an offshore fund with a U.S. investment manager is considered a U.S. person. If the end-user is a U.S. person, but the swap dealer is not a U.S. person, nor guaranteed by a U.S. person, nor in a control relationship with a U.S. person, then the Prudential Regulators and the CFTC may permit the swap dealer to comply with certain foreign margin regulations to which it is subject in lieu of complying with analogous U.S. margin rules. This "substituted compliance" is only permitted if the swap dealer's applicable U.S. regulator has determined that such foreign regulations are "comparable" to the U.S. rules.

WHAT ARE THE VARIATION MARGIN AND INITIAL MARGIN REQUIREMENTS?

The extent to which the margin rules apply to a financial end-user depends largely on whether it has "material swaps exposure" (or "MSE"). A financial end-user is considered to have MSE if it (combined with its affiliates) has an average daily aggregate gross notional amount of uncleared swaps, FX forwards and FX swaps outstanding in excess of $8 billion, as measured during a certain test period (defined as the months of June, July and August of the prior calendar year). Swap dealers must collect variation margin (VM) from and post VM to all financial end-users, *i.e.*, both end-users with MSE and end-users without MSE. On the other hand, swap dealers are only required to collect initial margin (IM) from and post IM to end-users with MSE. End-users without MSE, therefore, remain free to negotiate IM terms with their dealer counterparties without regulatory restriction.

Variation Margin

Swap dealers must calculate, and collect or post (as the case may be), VM based on changes in mark-to-market trade values at least once every business day. A minimum transfer amount, not to exceed $500,000, applicable to the aggregate deliverable amount of IM and VM is permitted.

Initial Margin

Calculating minimum IM delivery amounts is less straightforward. Both sets of U.S. regulations offer two options: The first is based on a look-up table set forth in the rules which specifies the percentage that must be applied to the notional amount of each type and duration of swaps in order to determine the amount of IM. The second option permits swap dealers to develop proprietary, risk-based methodologies to calculate IM delivery requirements, which must meet various

2. CFTC's cross border rules are still in proposed form.

regulatory guidelines and secure approval by regulators. We expect the latter approach to be more capital efficient in many cases and especially popular among larger, global swap dealers with the capacity to develop bespoke risk models.[3] Either way, the margin rules do permit parties to agree to minimum exposure thresholds of up to $50 million (on a group basis) before IM must be delivered.

WHAT TYPES OF ASSETS ARE ELIGIBLE TO BE USED AS COLLATERAL?

Margin may be posted in cash in U.S. dollars and the relevant swap's settlement currency. Subject to certain mandatory haircuts, parties also may post other assets, such as short-term government and agency debt (0.5% haircut), other government, agency and publicly traded debt (up to 4%, depending on maturity), certain listed U.S. equity securities (15-25%) and gold (15%). Given these significant haircuts, end-users should ensure they have ready sources for obtaining "higher quality" collateral, such as cash and short-term government debt. Consequently, firms may wish to have multiple prime brokerage, repo and securities lending relationships in place in order to exchange assets for cash on short notice. Further, because such "collateral transformation" services also come at a price, firms also should evaluate their own internal collateral management procedures to ensure assets collateralize their various derivatives, repo, stock borrowing and securities trades as optimally as possible.

HOW WILL COLLATERAL BE HELD?

Swap dealers and end-users with MSE facing one another must arrange for a third-party custodian to hold and segregate all posted collateral. Such collateral cannot be rehypothecated or otherwise used by either party (unless and until a termination event permits close-out and liquidation of posted credit support). When a swap dealer trades with end-users without MSE, the parties may negotiate collateral holding and use provisions as they see fit.

WILL END-USERS NEED NEW OR AMENDED SWAP AGREEMENT DOCUMENTATION?

To the extent that swaps are traded on the basis of the industry-standard ISDA Master Agreement, end-users will need to update their Credit Support Annexes (CSAs) for any new positions executed after the compliance date. The CSAs between swap dealers and end-users without MSE will need to reflect new regulatory requirements such as daily VM call, limited eligible collateral and modified haircuts. For end-users with MSE, additional changes to the CSAs and new account control agreements will be necessary to satisfy regulatory IM calculation requirements and incorporate risk-based IM calculation methods (as applicable), as well as accommodate third-party IM margin custodial arrangements.

Although swaps executed before relevant compliance deadlines are grandfathered and may use preexisting swap credit support terms, if any such swaps are subject to master netting agreements, the rules require that they be considered for aggregate VM and IM delivery calculation as well. End-users should consider whether combining their pre- and post-compliance trades under a revised CSA will provide capital or administrative efficiencies.

WHEN ARE THESE MARGIN RULES EFFECTIVE?

Regulators are phasing in the rules, and end-users that are most active in the uncleared swap markets should be will be prepared to comply sooner than others.

Variation Margin

For most end-users, VM requirements become effective first. Compliance is required beginning September 1, 2016 for all trades executed between a swap dealer and any given end-user if the aggregate notional amount of uncleared swaps between the two parties and their respective affiliates exceeds $3 trillion during March,

3. Because swap dealers may develop their own IM calculation models and margin rules vary across international jurisdictions, market participants could face the prospect of trying to analyze myriad IM calculation methodologies whenever entering into new trades or disputing agent calculations. Relief, however, may come from the Standard Initial Margin Model (SIMM), which is currently being developed by the International Swaps and Derivatives Association (ISDA). SIMM is intended to create a robust IM calculation model that satisfies regulatory requirements while appealing to a broad set of swap dealers. By standardizing IM calculation, delivery, holding and dispute resolution terms used by dealers, SIMM may simplify the transition to the mandatory margin regime for end-users who engage multiple swap dealers. SIMM documents currently remain works in progress.

April and May 2016. For all other relationships between swap dealers and end-users, March 1, 2017 is the relevant compliance date.

Initial Margin

The IM requirements will be phased-in over the next five years. As shown below, the deadline applicable to a given dealer-customer relationship depends on the notional amount of uncleared swaps executed between the parties (and their affiliates) during the most recent months of March, April and May.

Notional Amount	*Implementation Deadline*
Greater than $3 trillion	Sept. 1, 2016
$2.25 to $3 trillion	Sept. 1, 2017
$1.5 to $2.25 trillion	Sept. 1, 2018
$750 billion to $1.5 trillion	Sept. 1, 2019
Remainder	Sept. 1, 2020

CAN END-USERS MITIGATE THE COST OF POSTING MARGIN BY USING CLEARED SWAPS?

End-users should take note of available products in the cleared swap markets. Many varieties of swaps are increasingly available as centrally cleared products. In general, these products have lower margin requirements than their uncleared cousins. That said, weighing the choice between uncleared and cleared products will not always be easy. End-users will need to consider clearinghouse margin requirements, broker fees, clearinghouse fees, on-boarding requirements and potential basis risk when deciding whether to migrate uncleared positions to the centrally cleared space.

* * *

In the long history of Dodd-Frank Act regulatory roll-out, implementation of uncleared swap margin rules will be among the biggest changes affecting the economic returns on financial end-users' swaps. While end-users may enjoy reduced counterparty credit risk as these rules effectively force swap dealers to deleverage outstanding swap positions, many likely will find transaction and capital costs of uncleared swaps to increase due to these rules. Certainly, every end-user needs to focus on the pending impact of the rules on their uncleared swap trading strategies and begin preparation at all levels, including operations, documentation, risk analysis and economic modeling.

QUESTIONS

If you have questions regarding the matters discussed in this client alert, please call your usual contact at Richards Kibbe & Orbe LLP or one of the persons listed below.

Julia Lu
New York
212.530.1892
jlu@rkollp.com

John A. Clark
New York
212.530.1834
jclark@rkollp.com

DISCLAIMER