

Proposed Margin Rules For Uncleared Swaps Will Be Costly

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On Sept. 3, the Federal Reserve, the Federal Deposit Insurance Corp., the Office of the Comptroller of the Currency, the Farm Credit Administration, and the Federal Housing Finance Agency (collectively, the "prudential regulators") jointly issued proposed regulations implementing certain provisions of the Dodd-Frank Act relating to margin requirements for uncleared swaps and capital requirements for certain entities (the "margin regulations").

Subject to certain exceptions, the margin regulations would require swap dealers, security-based swap dealers, major swap participants, and major security-based swap participants regulated by the prudential regulators (collectively, "covered swap entities") to post and collect initial and variation margin on uncleared swaps with, among other market participants, private funds, investment companies, commodity pool operators, investment advisers, commodity trading advisers, broker-dealers, securities-holding companies, and other so-called "financial end users" (collectively, "financial end users").

"Private funds" are funds excluded from registration under Sections 3(c)-1 or 3(c)-7 of the Investment Advisers Act, and thus in practice, a significant swath of the private hedge fund and other similar fund industry would be "financial end users." The margin regulations would also establish minimum levels of initial and variation margin that must be posted and collected, establish eligibility requirements for this collateral, bar rehypothecation of initial margin, and impose other limitations and requirements.

The margin regulations are a revised version of regulations proposed in 2011 by the prudential regulators to implement the requirements of Sections 731 and 764 of the Dodd-Frank Act. It is expected that the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission will implement companion regulations that will apply to the covered swap entities they regulate.

The initial proposed version of the margin regulations received a significant number of comments, particularly around the requirements that covered swap entities post and collect initial and variation margin on uncleared swaps with "corporate end users." The re-proposed margin regulations exclude "corporate end users" from mandatory requirements for posting and collecting initial and variation



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margin on their uncleared swaps with covered swap entities. Financial end users were not, however, excluded from these requirements.

The margin regulations include a broad definition of financial end users that will cover many types of investment funds and their related entities, including securities-holding companies, broker-dealers, investment advisers, registered and certain exempt investment companies, private funds, commodity pools, commodity pool operators, commodity trading advisers, bank-holding companies and their affiliates, depository institutions, lenders and insurance companies.

As noted above, because "private funds" cover funds excluded from registration under Sections 3(c)-1 or 3(c)-7 of the Investment Advisers Act, a significant swath of the private hedge fund and other similar fund industry would be "financial end users." Significantly, the margin regulations also include a catch-all to permit prudential regulators to include other entities as financial end users "where appropriate for safety and soundness purposes or to address systemic risk."

As proposed, covered swap entities would be required to post and collect initial and variation margin for trades with financial end users as follows:

- A covered swap entity must collect and post initial margin (i.e., on a two-way basis) for uncleared swaps with financial end users that have "material swaps exposure."
 - "Material swaps exposure" is defined as an average daily notional amount of uncleared swaps, security-based swaps, foreign exchange forwards and foreign exchange swaps over a three-month period, calculated on a collective basis among affiliated entities, exceeding \$3 billion. This calculation includes all uncleared swap and security-based swap and security-based swap transactions by the financial end user and its affiliates with all counterparties (including foreign exchange swaps and forwards that are not considered "swaps" for many regulatory purposes).
- Covered swap entities must calculate the initial margin to be collected or posted either based on (1) a margin schedule set forth in the margin regulations or (2) an internal model that satisfies certain criteria set forth in the margin regulations that has been approved by a prudential regulator.
- The threshold for determining whether initial margin must be posted or collected is \$65 million, calculated on an aggregate and consolidated basis. If the financial end user, together with its affiliates, is required to post less than \$65 million in aggregate initial margin calculated as described above with a particular covered swap entity and its affiliates, the covered swap entity may, but is not required to, require the financial end user to post and collect initial margin.

- Variation margin must be posted and collected on a daily basis, and subject to the minimum threshold requirement below, there is no threshold for variation margin. Also, whether a financial end user has "material swaps exposure" is not relevant for determining whether a covered swap entity must post and collect variation margin.
- Both initial and variation margin payments can be delayed until the amount required to be transferred from a particular counterparty to another (on an aggregate, consolidated basis) is greater than \$650,000.
- Margin collection and posting requirements may be subject to reduction pursuant to master cross-netting arrangements, subject to certain limitations.
- Only cash qualifies as eligible variation margin collateral. Permissible initial margin collateral includes cash, gold, and governmental, corporate bond, and equity securities meeting specified requirements.
- Covered swap entities must segregate initial margin at an unaffiliated third-party custodian, and neither collected nor posted initial margin may be rehypothecated. Variation margin is not subject to the segregation requirement or rehypothecation restriction.

The margin regulations will be costly for covered swap entities and financial end users. The preamble to the margin regulations cites studies by the International Swaps and Derivatives Association and the Basel Committee on Banking Supervision/International Organization of Securities Commissions, estimating the cost of U.S. initial margin requirements at approximately \$280 billion and \$315 billion, respectively, if internal models are used to calculate the margin amounts.

The preamble also cites an ISDA study concluding that if internal models are not used, the cost of U.S. initial margin for uncleared swaps could reach \$3.57 trillion. The preamble to the margin regulations states prudential regulators estimate the cost of posting and collecting variation margin to be low because the prudential regulators view posting and collecting variation margin as an existing best practice.

What should investment funds do now? First, investment funds should consider the potential impacts of the margin regulations on their trading strategies, trading costs, and universe of potential counterparties for trading uncleared swaps. For the reasons described above, we expect that the margin regulations, if adopted as proposed, will increase the costs of trading uncleared swaps and decrease the universe of potential counterparties.

Second, the margin regulations are not yet final, and to the extent investment funds view the margin regulations as having a negative impact on their business, investment funds should consider

commenting on the margin regulations or otherwise becoming involved in the public policy process.

Gov. Daniel Tarullo of the Federal Reserve prepared a useful summary memorandum to the margin regulations that can be found [here](#). Comments are due on the proposed regulation 60 days after its publication in the Federal Register.

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