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CLIENT MEMORANDUM

Prudential Regulators Propose Margin Requirements For Non-Cleared Swaps

October 21, 2014

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The Prudential Regulators[1] recently proposed rules establishing initial and variation margin requirements for "covered swap entities" participating in non-cleared swaps.[2] CSEs generally include swap dealers and major swap participants as well as security-based swap dealers and participants that are banks and subsidiaries of bank holding companies. As a result, most of the major swap dealers in the U.S. will be subject to the new requirements, if adopted as proposed. The

[1] The Prudential Regulators are the Federal Deposit Insurance Corporation, the Office of Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Farm Credit Administration and the Federal Housing Financial Agency.

[2] Margin and Capital Requirements for Covered Swap Entities, 79 Fed. Reg. 57348 (Sept. 24, 2014) (the "2014 Proposal"). The 2014 Proposal also proposes capital requirements for covered swap entities.

A "covered swap entity" ("CSE") is an entity that (i) is regulated by a Prudential Regulator, (ii) is a swap dealer, major swap participant, security-based swap dealer or major security-based swap participant and (iii) enters into a non-cleared swap or non-cleared security-based swap.

A "non-cleared" swap is a swap that is not subject to mandatory clearing or a swap with respect to which a party to the swap is eligible for, and takes advantage of, an exemption from the mandatory clearing requirement. For more information on the mandatory clearing requirement, please see our client memorandum dated August 1, 2013, entitled Mandatory Swap Clearing and The End-User Exception.

margin requirements would apply to any non-cleared swap to which a CSE becomes a party on or after the applicable compliance date. Comments on the 2014 Proposal are due by November 24, 2014.

For purposes of this memorandum the term "swap" refers to both swaps and security-based swaps. The 2014 Proposal incorporates the term "swap" as defined in the Commodity Exchange Act (the "CEA") and "security-based swap" as defined in the Securities Exchange Act of 1934. The CEA definition of "swap" excludes, among other things, *bona fide* foreign exchange spot transactions. Pursuant to a determination by the Secretary of the Treasury, certain foreign exchange forwards and foreign exchange swaps are also excluded from the definition of "swap" and are therefore also outside the scope of non-cleared swaps that are subject to the 2014 Proposal.[3]

I. Background

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") requires the Prudential Regulators to adopt joint rules for Swap Entities under their respective jurisdictions that impose initial and variation margin requirements on all non-cleared swaps.[4] The Prudential Regulators originally published proposed margin requirements for CSEs in 2011 (the "2011 Proposal"). The 2014 Proposal supersedes the 2011 Proposal, and incorporates principles

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[3] Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, 77 Fed. Reg. 69694 (Nov. 20, 2012). For more information, please see our client memorandum dated November 20, 2012, entitled Treasury Excludes FX Swaps and FX Forwards From Most CFTC Oversight.

[4] The Dodd-Frank Act also requires the Commodity Futures Trading Commission (the "CFTC") and the Securities and Exchange Commission (the "SEC") to adopt rules imposing margin requirements on Swap Entities that are not CSEs.

On September 17, 2014, the CFTC approved proposed rules on margin requirements for non-cleared swaps for swap dealers and major swap participants. Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants; Proposed Rule, 79 Fed. Reg. 59898 (Oct. 3, 2014). Comments are due by December 2, 2014. The CFTC's proposed rules are substantially similar to the 2014 Proposal, except that, among other smaller differences, such rules (i) include more specific documentation requirements, (ii) do not include a specific rule regarding margin for non-financial end users and (iii) do not include rules regarding the application of margin requirements for foreign uncleared swaps (as this issue was previously addressed in the CFTC's cross-border guidance).

On January 22, 2013, the SEC proposed rules regarding capital, margin and segregation requirements for security-based swap dealers and major security-based swap participants. Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker Dealers, 78 Fed. Reg. 4366 (Jan. 22, 2013). The SEC's proposed rules differ from the CFTC's proposal as well as the 2014 Proposal in a number of respects. For example, the SEC's proposal would not require the bilateral posting of collateral by security-based swap dealers, would require a security-based swap dealer to take a capital charge if it elects not to charge initial margin to a corporate end user, would prohibit the use of threshold amounts in calculating margin and would allow for use of equity security-based swaps in portfolio margining accounts. On May 1, 2013, the SEC reopened the comment period on this proposal. The SEC has not adopted or reproposed these rules.

from the international framework for margin requirements on non-cleared swaps that were finalized in 2013 by the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions.

The margin requirements, as proposed, would govern all of a CSE's non-cleared swap activities without regard to whether the CSE is registered as a Swap Entity[5] with respect to a certain type of swap activity. In addition, the 2014 Proposal, if adopted as proposed, would establish only minimum initial and variation margin requirements and would not prevent a CSE from collecting or posting margin beyond the amount required under the proposed rules.

The 2014 Proposal would require compliance with the variation margin requirements by CSEs and their counterparties beginning December 1, 2015 but would provide for a four-year, staggered implementation period for initial margin requirements. Under the phased-in approach, the initial margin requirements would apply to CSEs and their counterparties depending upon whether both the CSE's and the counterparty's swap activity exceeded a designated "volume threshold." The first compliance date for CSEs and their counterparties who each separately exceed the highest "volume threshold" would be December 1, 2015. The last compliance date for CSEs and their counterparties that exceed only the lowest "volume thresholds" would be December 1, 2019. The threshold would be calculated with respect to the average daily aggregate notional amount of non-cleared swaps, non-cleared security-based swaps, foreign exchange forwards[6] and foreign exchange swaps ("Covered Swaps") for June, July and August of the relevant year (i.e., immediately preceding each year's December 1 compliance date) executed by (i) a CSE and its affiliates with any counterparty, on the one hand, and (ii) the CSE's counterparty and its affiliates with any counterparty, on the other hand. The proposed rules require the CSE to document credit support arrangements with a Swap Entity or financial end user.[7]

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5 A "Swap Entity" is defined as a swap dealer, major swap participant, security-based swap dealer or major security-based swap participant.

6 As noted above, the proposed margin rules would apply only to non-cleared swaps, which exclude foreign exchange forwards subject to the determination by the Secretary of the Treasury and *bona fide* foreign exchange spot transactions. Nevertheless, a CSE would be required to include the notional amount of such foreign exchange forwards when calculating whether it meets the compliance threshold for each of the staggered compliance dates, as well as when calculating its "material swaps exposure" (as discussed below).

7 A "financial end user" generally is a non-Swap Entity counterparty that is, among other things, one of the following types of entities (as defined under applicable laws and regulations): (i) a bank holding company or an affiliate thereof; (ii) a savings and loan holding company; (iii) a depository institution; (iv) a foreign bank; (v) a federal credit union; (vi) a securities holding company; (vii) a broker or dealer; (viii) an investment adviser; (ix) a registered investment company, business development company or private investment fund; (x) a commodity pool, commodity pool operator or commodity trading advisor; (xi) an employee benefit plan; (xii) an insurance company; (xiii) an entity that is, or holds itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing or otherwise trading in loans, securities, swaps, funds or other assets; or (xiv) an entity that would be a financial end user or a Swap Entity if it were organized in the United States. An entity may also be a financial end user if a Prudential Regulator determines that the entity should be treated as such.

The proposed rules exclude from the definition of "financial end user" entities that are sovereign entities, multilateral development banks, the Bank for International Settlements, certain entities exempt from the definition of financial entity under the CEA and certain affiliates exempt from clearing

II. Types of CSE Swap Counterparties

The 2014 Proposal distinguishes among four types of swap counterparties with which a CSE may transact: (1) counterparties that are Swap Entities; (2) counterparties that are financial end users with a material swaps exposure;[8] (3) counterparties that are financial end users without a material swaps exposure; and (4) other counterparties, including non-Swap Entities that are "commercial end users" (i.e., non-financial end users that generally trade swaps in order to hedge commercial risk), sovereigns and multilateral development banks.

A. *Swap Entities and Financial End Users*

Initial Margin Requirements

Under the 2014 Proposal, a CSE that transacts with another Swap Entity or with a financial end user that has a material swaps exposure would be required to collect from that entity the minimum required amount of initial margin calculated using one of two methods. As discussed below, any initial margin a counterparty is required to post to a CSE would be required to be held at a third-party custodian. The CSE acting as counterparty to the Swap Entity or financial end user having a material swaps exposure would also be required to post initial margin, the amount of which would depend on whether the counterparty is a Swap Entity or a financial end user having a material swaps exposure. If the counterparty is a Swap Entity, then the CSE would be required to post the minimum amount of initial margin that the counterparty is required to collect under the margin rules applicable to that entity.[9] If the counterparty is a financial end user that has a material swaps exposure, the CSE would be required to post an initial margin amount equal to the amount the CSE would be required to collect if the CSE were in the place of the counterparty. If the counterparty is a financial end user that does not have a material swaps exposure, the CSE would not be required to post initial margin to that financial end user counterparty.

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under the CEA or the Securities Exchange Act of 1934. Sovereign entities, multilateral development banks and the Bank for International Settlements are treated as "other counterparties" as described in the next section.

8 A financial end user would be deemed to have a "material swaps exposure" if the entity's average daily aggregate notional amount exceeds $3 billion for Covered Swaps with all counterparties during June, July and August of the previous year. The 2014 Proposal is silent regarding the methods that a CSE can reasonably use to confirm whether its counterparty is below or above the $3 billion threshold.

For purposes of calculating its material swaps exposure, a financial end user would be required to aggregate such exposure with that of its affiliates, which include companies that control, are controlled by or are under common control with such financial end user. The Prudential Regulators requested comment on whether advised and sponsored funds and sponsored securitization vehicles should be considered to be affiliates of the investment adviser or sponsor even if there is no control. The Prudential Regulators noted that, in their view, such entities should not be considered to be affiliates unless there is control.

9 If a Swap Entity counterparty is also a CSE, then the CSE will look to the margin rules promulgated by the Prudential Regulators. If a counterparty is not a CSE, the amount of collateral the CSE will be required to post is based on SEC or CFTC margin rules.

Where initial margin is required, a CSE would be required to calculate and collect initial margin on at least a daily basis. The amount of initial margin required to be collected would need to be calculated in one of two ways. First, a CSE could adopt an internal model to calculate initial margin amounts. The CSE's Prudential Regulator would have to approve the CSE's internal model, and the model would need to meet specified requirements. For example, an internal model would need to meet various quantitative requirements such as a 10-day close-out period assumption and would have to address other material risks of the particular transaction. The internal model may also calculate initial margin taking into account any eligible master netting agreement that governs its non-cleared swaps with a particular counterparty. That agreement, however, would have to first satisfy certain criteria including that it be legally enforceable, which implies that parties would need an enforceability opinion. The CSE would also have to have in place and document policies and procedures that subject the model to, among other things, periodic review, compliance oversight and risk management analysis. Furthermore, the Prudential Regulators noted that a CSE's internal model would need to be "at least as conservative" as the models generally used by swap clearinghouses. The 2014 Proposal did not elaborate on how that determination would be made. Alternatively, a CSE could use the standardized model set forth in Appendix A to the 2014 Proposal, which determines the amount of initial margin to be posted or collected as a percentage of a swap's notional amount.

Under the 2014 Proposal, a CSE would be permitted to establish a threshold amount on a counterparty-by-counterparty basis for initial margin below which the CSE (together with its affiliates) would, at all times, be unsecured in relation to a counterparty and its affiliates. The maximum threshold allowed under the rules would be $65 million. The 2014 Proposal is silent on how a CSE and its counterparty should allocate the designated threshold amount. As a result, it appears to be a point that may be negotiated between the parties to a swap.

Variation Margin

With respect to swaps entered into with a counterparty that is a Swap Entity or a financial end user *with or without* a material swaps exposure, the 2014 Proposal, if adopted as proposed, would require a CSE to collect variation margin from or post variation margin to a counterparty in an amount equal to the increase or decrease, as applicable, in the value of the swap since the counterparties' last exchange of variation margin. A CSE would be required to collect the full amount of required variation margin subject to a minimum transfer amount, as discussed below, if applicable. A CSE may calculate variation margin taking into account any eligible master netting agreement that governs its non-cleared swaps with a particular counterparty. As discussed above, that agreement would have to satisfy certain criteria and be legally enforceable. Variation margin would be required to be calculated and exchanged no less frequently than daily. The Prudential Regulators, however, did not address whether the statutory obligation of a CSE to "collect" variation margin would be satisfied if such margin were held with a third-party custodian similar to how initial margin is permitted to be held at a third-party custodian.

Minimum Transfer Amount

The 2014 Proposal provides for a permitted minimum margin transfer amount that cannot exceed $650,000. If adopted as proposed, a CSE would not be obligated to post initial or variation margin to or collect initial or variation margin from any

type of counterparty unless and until the requisite aggregate amount of initial and variation margin exceeds $650,000 (or such lower amount as the parties to the swap may agree). Subject to any applicable initial margin threshold, once the minimum transfer amount is surpassed, the entire amount of the required margin would be required to be collected or posted.

B. *Other Counterparties (Including Non-Financial End Users)*

In general, the 2014 Proposal, if adopted, would not require a CSE to post margin to, or collect margin from, non-financial end users or other non-Swap Entity counterparties.

With respect to entities that are both commercial end users and not financial end users, the 2014 Proposal notes that the Dodd-Frank Act "does not contain an express exemption" from the margin requirements but instead directs the Prudential Regulators to follow a "risk-based approach" in establishing margin requirements. Accordingly, the proposed rules, if adopted, would grant CSEs the discretion to collect margin from commercial end users based on the Prudential Regulators' view that these counterparties and these types of swaps are low risk. Thus, a CSE could choose to collect initial and variation margin from such counterparties only "at such times and in such forms and amounts (if any) as the [CSE] determines would appropriately address the credit risk posed by swaps entered into with 'other counterparties.'"[10] This approach is intended to be consistent with current market practice and the existing internal credit processes and standards of many Swap Entities.

With respect to non-financial end users that are not commercial end users, as well as with respect to other non-Swap Entities (such as sovereign entities, multilateral development banks, the Bank for International Settlements, and captive finance companies and Treasury affiliates exempt from clearing under the Dodd-Frank Act) the proposed rules provide for the same, discretionary risk-based approach toward collecting margin.

III. Types of Eligible Collateral

Under the 2014 Proposal, variation margin must be posted in cash. Initial margin, on the other hand, may be posted in any of the following:

- cash in certain specified currencies;[11]
- debt securities issued by, or unconditionally guaranteed by, the Department of the Treasury or another U.S. government agency whose obligations are fully guaranteed by the full faith and credit of the U.S. government;

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[10] "Financial entities," as defined in the CEA, are not commercial end users. Mutual funds, private funds and pension funds are financial entities under the CEA. Thus, a CSE would not be permitted to exercise discretion in the collection of initial and variation margin from these types of funds.

[11] The 2014 Proposal provides that the following would be eligible currencies for posting cash: (i) United States Dollars, (ii) Canadian Dollars, (iii) Euros, (iv) United Kingdom Pounds, (v) Japanese Yen, (vi) Swiss Francs, (vii) New Zealand Dollars, (viii) Australian Dollars, (ix) Swedish Kronor, (x) Danish Kroner, (xi) Norwegian Krone and (xii) any other currency as determined by the Prudential Regulators.

- publicly traded debt securities issued by U.S. government-sponsored enterprises operating with direct financial assistance from the U.S. government that enable the repayment of such debt securities, or publicly traded debt securities for which the issuers have adequate capacity to satisfy their financial commitments, as determined by the appropriate federal agencies; and
- publicly traded common equity securities included in the Standard & Poor's Composite 1500 Index or certain other indices.

To the extent that a CSE posts non-cash collateral and non-U.S. dollar-denominated cash collateral as initial margin, the valuation of such collateral would be subject to an additional haircut calculated according to Appendix B to the 2014 Proposal.

IV. Segregation of Collateral

The 2014 Proposal does not address segregation of variation margin.[12] As a result, it appears as though counterparties, such as mutual funds, could continue to post variation margin with the fund custodian provided that the counterparty to the swap agreed. The 2014 Proposal, if adopted as proposed, would require that any collateral posted by a CSE to its counterparty (other than variation margin) be held at a third-party custodian. Only initial margin that a counterparty is required to post to a CSE, however, would be required to be held at a mutually agreed upon third-party custodian. Such custodian could not be an affiliate of the CSE or counterparty. The proposed rules provide that the parties would need to execute a custodial agreement and that such agreement would have to be enforceable even in bankruptcy, and include provisions that prohibit the custodian from rehypothecating, repledging, reusing or otherwise transferring the funds held by it. The Prudential Regulators also requested comment on whether they should permit a limited degree of rehypothecation, repledging and reuse of initial margin collateral.

V. Documentation

The 2014 Proposal would require CSEs to execute documentation with each entity that is a Swap Entity or financial end user that contractually provides for the collection and posting of initial and variation margin between the parties. The documentation would be required to provide for, among other things, the method of valuing each swap and resolving disputes regarding swap valuations or valuations of assets posted as margin. The Prudential Regulators stated that compliance with CFTC or SEC rules regarding the documentation of swaps and security-based swaps, as applicable, would satisfy the proposed rules regarding documentation under the 2014 Proposal.

It is expected that CSEs may require amendments to existing documentation to ensure compliance with the applicable rules. For example, parties to an ISDA Credit Support Annex may have negotiated the ability to post various types of non-

[12] The Prudential Regulators explained that they did not require segregation for variation margin because variation margin generally offsets the current exposure arising from actual changes in the market value of a derivative as opposed to potential exposure arising from future changes in such transaction that occur during the closeout of the exposure.

cash collateral as variation margin. If adopted as proposed, the new rules would necessitate the amendment of such provisions in order to conform to the restrictions on eligible variation margin collateral.

VI. Cross-Border Application

In light of the global nature of derivative transactions, the 2014 Proposal also proposed that application of the margin rules would not apply to foreign non-cleared swaps of a foreign CSE.[13] In addition, a foreign CSE trading with a U.S. entity would be permitted to comply with a foreign regulatory framework for non-cleared swaps to the extent that the Prudential Regulators have jointly approved such framework.

VII. Conclusion

The 2014 Proposal and the CFTC proposed rules went a long way toward addressing a number of the risk management and operational concerns expressed by swap market participants regarding the earlier proposals. Although there remain a number of points that will need to be clarified, such as how the initial margin threshold will be allocated and how segregation will work with respect to variation margin, the 2014 Proposal and CFTC proposed rules offer a thoughtful approach to important issues such as adoption of a reasonable implementation schedule, cross-border application and use of custodians to hold customer margin.

If you have any questions concerning the foregoing or would like additional information, please contact P. Georgia Bullitt (212-728-8250, gbullitt@willkie.com), Jack I. Habert (212-728-8952, jhabert@willkie.com), Jed Doench (212-728-8687, jdoench@willkie.com), Jonathan C. Burwick (212-728-8108, jburwick@willkie.com), Bissie K. Bonner (212-728-8955 bbonner@willkie.com) or the Willkie attorney with whom you regularly work.

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October 21, 2014

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[13] A foreign CSE is an entity that is none of the following: (i) an entity organized in the U.S., (ii) a U.S. branch or subsidiary of a foreign bank, (iii) a branch or office of a U.S. organized entity or (iv) an entity controlled by a U.S. organized entity. A foreign non-cleared swap would be a swap in which neither the counterparty to the foreign CSE nor the guarantor of either party, if applicable, is a "U.S. entity" (as defined in the 2014 Proposal).