

CLIENT MEMORANDUM

Reminder: Swap Variation Margin Requirements Become Effective March 1, 2017

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AUTHORS

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Beginning **March 1, 2017**, firms that are “Financial End Users,”¹ including registered investment companies, business development companies, private funds, commodity pools, employee benefit plans, investment advisers, broker-dealers, insurance companies and certain banking and lending entities, will be required to *post* variation margin to and *collect* variation margin from dealers. Under regulations adopted by U.S. bank regulators (the “Prudential Regulators”)² and the Commodity Futures Trading Commission (“CFTC”) pursuant to Dodd-Frank³ (the “Swap Margin Rules”),⁴ swap dealers

¹ See PR Margin Rules (defined below) § __.1; CFTC Rule 23.151. The Financial End User definition is different from the “financial entity” definition in Section 2(h)(7)(C) of the Commodity Exchange Act.

² The Prudential Regulators are the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve (the “Federal Reserve”), the Federal Deposit Insurance Corporation, the Farm Credit Administration, and the Federal Housing Finance Agency.

³ The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010) (“Dodd-Frank”).

⁴ Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 74,840 (Nov. 30, 2015) (codified at 12 C.F.R. Parts 45, 237, 349, 624 and 1221) (“PR Margin Rules”); Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 636

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and other “Covered Swap Entities”⁵ will be required to post and collect variation margin with respect to uncleared swaps and security-based swaps entered into with Financial End Users on or after March 1, 2017.⁶ Similar rules with the same compliance date have been adopted by regulators in Europe,⁷ Canada, Switzerland, Singapore, Japan, and Hong Kong.

As a result of the Swap Margin Rules, prior to March 1, 2017, Financial End Users transacting with Covered Swap Entities will need to have in place: (i) Credit Support Annexes (“CSAs”) or other collateral agreements, (ii) tri-party control agreements, if the Financial End User is a registered investment company⁸ or otherwise requires variation margin to be held through a custodian, and (iii) updates to existing CSAs and collateral documentation to address the new requirements. The changes may be made through negotiation of new or amended CSAs (or other collateral agreements) and tri-party control agreements (if required), or adherence to the ISDA 2016 Variation Margin Protocol (“ISDA VM Protocol”). Financial End Users will need to work with Covered Swap Entities to determine which eligible collateral types the Covered Swap Entities intend to post, and will accept for posting, and the haircuts that will apply. Trades executed before the March 1, 2017 compliance date will not be subject to the variation margin requirements. Netting of variation margin across pre- and post-March 1, 2017 transactions will only be permitted if all such transactions are subject to documentation that complies with the variation margin requirements of the Swap Margin Rules.

Implementation of the Swap Margin Rules will be a significant change for a number of Financial End Users who either have not had to post margin previously or have been a party only to unilateral margin arrangements under which they posted but did not receive margin. For example, some registered investment companies traditionally have not posted margin to, or collected margin from, dealers. Instead, they have simply segregated assets to cover their obligations under over-the-counter swap obligations by earmarking assets on their own books and records.

We have summarized below the key U.S. variation margin requirements. The applicable rules in other jurisdictions differ, in some cases, from the U.S. rules. Differences include the range of entities that are in scope, the type of transactions

(Jan. 6, 2016) (codified at 12 C.F.R. Part 23). The PR Margin Rules were separately adopted by each Prudential Regulator but are substantially identical and use the same subsection numbers. For ease of presentation, this memorandum cites to the common subsections of the PR Margin Rules as (e.g., “§ __.1”).

- ⁵ “Covered Swap Entities” means swap dealers, security-based swap dealers, major swap participants and major security-based swap participants.
- ⁶ See PR Margin Rules § __.1(e)(2); CFTC Rule 23.161(a)(2). Compliance with the Swap Margin Rules is phased-in, with different phase-in periods for the initial margin and variation margin requirements. The first compliance date for the initial and variation margin requirements was on September 1, 2016, but that date applied only to counterparties with very large positions (*i.e.*, on the order of \$3 trillion notional) and, thus, did not apply to most Financial End Users.
- ⁷ European Market Infrastructure Regulation (EU) No 648/2012.
- ⁸ To comply with Section 17(f) of the 1940 Act, investment companies registered under the 1940 Act are required to post margin payments with the fund’s custodian pursuant to a tri-party control agreement among the registered fund, the Covered Swap Entity, and the custodian.

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covered by the requirements and the types of instruments that are eligible for posting as collateral. The ISDA VM Protocol is designed to apply across jurisdictional lines so that market participants can comply with applicable variation margin requirements arising in a number of other jurisdictions.

Effect of Financial End User Status

Firms must determine whether they (or their clients) meet the definition of a “Financial End User” under the Swap Margin Rules because Covered Swap Entities are required to exchange variation margin on transactions with Financial End Users, but not with counterparties that are not Covered Swap Entities or Financial End Users.⁹

Applicability to “Swaps” and “Security-Based Swaps”

If a firm (or its client) is a Financial End User, it must determine whether its counterparties are Covered Swap Entities and whether the Covered Swap Entities are subject to the Swap Margin Rules adopted by the Prudential Regulators or those adopted by the CFTC. As a general matter, most swap dealers in the United States are subject to the Swap Margin Rules adopted by the Prudential Regulators. A Financial End User that trades with a Covered Swap Entity that is subject to the Swap Margin Rules adopted by the Prudential Regulators will be required to post and collect variation margin on *both* swaps and security-based swaps, whereas a Financial End User that trades with a Covered Swap Entity subject to the CFTC’s rules will be required to exchange variation margin only on swaps (and not security-based swaps). Financial End Users may want to obtain written representations from their counterparties regarding their regulatory status under the Swap Margin Rules in order to confirm whether they will be subject to regulatory margin requirements only on swaps or on both swaps and security-based swaps. ISDA has published a standardized letter—the ISDA Regulatory Margin Self-Disclosure Letter—that can be used to obtain such representations.¹⁰ The ISDA VM Protocol also contains representations regarding a counterparty’s regulatory status.

The Swap Margin Rules do not apply to physically settled foreign exchange derivatives (generally, currency trades having two-way settlement payment flows in different currencies, such as currency forwards) that are exempt from the swap definition under the determination issued by the Secretary of the Treasury.¹¹ However, the Federal Reserve separately issued a supervisory letter that appears to require certain banking entities subject to its supervision to collect and post variation margin on currency forwards and other physically settled foreign exchange transactions entered into with

⁹ See PR Margin Rules § __.4; CFTC Rule 23.153.

¹⁰ The ISDA Regulatory Margin Self-Disclosure Letter is available [here](#).

¹¹ See 80 Fed. Reg. 74,840, 74,842 (Nov. 30 2015); 81 Fed. Reg. 636, 638 (Jan. 6, 2016).

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“financial institutions.”¹² Both the definition of “financial institution” and the application of the supervisory letter are currently unclear. As a result, we recommend that Financial End Users confirm with dealers prior to transacting in currency forwards and other physically settled foreign exchange transactions that the clear exclusion in the Swap Margin Rules would be deemed to apply.

The Variation Margin Requirements

The key features of the requirements of the Swap Margin Rules include the following:

- *Bilateral exchange.* Covered Swap Entities are required to both collect variation margin from and post variation margin to Financial End Users.
- *Frequency.* Variation margin must be posted or collected each business day during the term of each swap and/or security-based swap (as applicable).
- *Marked-to-market.* The amount of variation margin required to be posted or collected is based on the marked-to-market change of the parties’ swaps and/or security-based swaps (as applicable).
- *Eligible collateral.* Eligible collateral for variation margin between Covered Swap Entities and Financial End Users generally includes (i) immediately available cash funds in (A) U.S. dollars or another major currency,¹³ or (B) the currency of settlement for the swap or security-based swap; (ii) U.S. Treasury securities, (iii) securities issued by U.S. government agencies guaranteed by the U.S. government, (iv) certain securities issued by foreign sovereign entities, (v) certain publicly-traded debt securities issued by, or asset-backed securities guaranteed by, U.S. government-sponsored enterprises, (vi) publicly-traded common equities included in the Standard & Poor’s Composite 1500 Index, (vii) certain money market funds that hold only U.S. Treasuries and cash in U.S. Dollars, and (viii) gold.¹⁴

¹² See Managing Foreign Exchange Settlement Risks for Physically Settled Transactions, SR 13-24 (Dec. 23, 2013) (incorporating requirements from the Basel Committee on Banking Supervision, *Supervisory Guidance for Managing Risks Associated with the Settlement of Foreign Exchange Transactions* (Feb. 2013)).

¹³ The major currencies currently include United States Dollars (USD), Canadian Dollars (CAD), Euro (EUR), United Kingdom Pound (GBP), Japanese Yen (JPY), Swiss Franc (CHF), New Zealand Dollar (NZD), Australian Dollar (AUD), Swedish Kronor (SEK), Danish Kroner (DKK) and Norwegian Krone (NOK).

¹⁴ See PR Margin Rules § __.6; CFTC Rule 23.156(b)(1)(ii).

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- *Haircutting of collateral.* The margin value of collateral is subject to the minimum haircuts specified in the rules.¹⁵ The minimum haircuts range from 0% for cash in U.S. dollars, a major currency or the settlement currency, to 25% for eligible publicly-traded common equities.
- *Minimum transfer amount.* Covered Swap Entities are not required to collect or post margin required under the Swap Margin Rules (including both initial and variation margin, if applicable) from or to any individual counterparty unless and until the combined amount of required regulatory margin that must be posted but has not yet been exchanged is greater than \$500,000.¹⁶
- *Multiple netting sets.* Covered Swap Entities are permitted, but not required, to establish separate “netting sets” in their trading documentation for which variation margin will be separately calculated and netted.¹⁷ A Covered Swap Entity may agree with a Financial End User to establish a separate netting set for swaps and/or security-based swaps executed before March 1, 2017 for which variation margin is not exchanged.¹⁸

The variation margin requirements in the Swap Margin Rules are minimum standards, and Covered Swap Entities and Financial End Users may contractually agree to stricter requirements.

Changes to Trading Documentation

Financial End Users that trade with Covered Swap Entities and that do not currently have in place documentation that provides for the exchange of variation margin (e.g., a CSA) will be required to enter into collateral agreements that provide for posting and collection of collateral that satisfies the Swap Margin Rules’ requirements. Firms that have CSAs or other collateral agreements in place that provide for variation margin posting and collection should review their agreements and confirm that they are consistent with the Swap Margin Rules, or revise them to be consistent with the rules.

Financial End Users have two primary options for implementing the required changes to their documentation: (i) entering into the ISDA VM Protocol and choosing among the options within the ISDA VM Protocol for entering into new CSAs or amending existing CSAs or (ii) negotiating new or amended CSAs or other acceptable forms of collateral agreements with each Covered Swap Entity outside of the ISDA VM Protocol. Whether a Financial End User should utilize the ISDA VM Protocol or individualized documentation will depend on its specific circumstances, including the provisions of its existing documentation, its need or desire for bespoke provisions, the acceptability of the options within the ISDA VM Protocol, its

¹⁵ See PR Margin Rules Appendix B; CFTC Rule 23.156(b)(2).

¹⁶ See PR Margin Rules § __.5(b); CFTC Rule 23.153(c).

¹⁷ See PR Margin Rules § __.5(a); CFTC Rule 23.153(d).

¹⁸ See PR Margin Rules § __.5(a)(3)(ii); CFTC Rule 23.153(d)(2)(ii). Any netting set containing one or more swaps executed on or after the March 1, 2017 compliance date will be subject to the variation margin requirements. *Id.*

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counterparties' willingness to consider individualized documentation, and timing considerations. The primary advantage of the ISDA VM Protocol is that it may facilitate faster compliance, particularly for firms with larger numbers of counterparties. One drawback to the ISDA VM Protocol is that it amends parties' CSAs through separate documentation and does not generate an amended and restated CSA in a single document, which may make it more difficult for some firms to interpret and implement their CSAs. Another limitation of the ISDA VM Protocol is that it does not provide an option to create a tri-party control agreement or allow for the creation of a new CSA with language providing for the segregation of variation margin at a third-party custodian. As a result, for registered investment companies that do not have control agreements and CSAs in place, the ISDA VM Protocol may not provide a practical solution.

We have outlined below some of the key provisions of the ISDA VM Protocol.

ISDA VM Protocol

The ISDA VM Protocol, like previous ISDA Dodd-Frank protocols, requires parties to adhere to the ISDA VM Protocol and exchange questionnaires that provide information to the other counterparty and contain elections.¹⁹ Thus, adhering to the ISDA VM Protocol is a bilateral process that requires coordination between the Financial End User and the Covered Swap Entity. The ISDA VM Protocol is available for electronic adherence on Markit's ISDA Amend platform.²⁰

The ISDA VM Protocol provides adherents with three main options for revising their trading documentation:

- **"Amend."** This option amends the parties' existing CSA to comply with the variation margin requirements. If this option is chosen, variation margin will be exchanged for all covered transactions between the parties, rather than just for transactions executed on and after the relevant compliance date (March 1, 2017 in the U.S.).
- **"Replicate-and-Amend."** This option replicates the parties' existing CSA and amends it to comply with the variation margin requirements, but this replicated and amended CSA only applies to trades executed on and after the relevant compliance date (March 1, 2017 in the U.S.). The parties' existing CSA remains in place and applies to trades executed prior to the relevant compliance date.
- **"New CSA."** This option creates a new CSA with standard terms set forth in an exhibit (subject to certain optional elections that may be made by the parties). This new CSA applies only to trades executed on and after the relevant compliance date (March 1, 2017 in the U.S.). Any existing CSA will continue to apply to trades executed prior to the relevant compliance date.

¹⁹ The documentation for the ISDA VM Protocol is available [here](#).

²⁰ See <http://www.markit.com/product/isda-amend>.

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The “Amend” and “Replicate-and-Amend” methods allow parties to customize certain provisions of their amended CSAs to reflect their commercial and operational requirements, such as the notification time for margin calls²¹ and the minimum transfer amount. Parties that select the “New CSA” method have additional options for customizing the standard form of new CSA, including options with respect to eligible collateral, the valuation agent, specifying a custodian, and interest, among other options.

Registered Funds

Mutual funds and other funds registered under the 1940 Act will be required to post margin with the fund’s custodian pursuant to a tri-party control agreement. Registered funds must put these agreements in place by the March 1, 2017 deadline, in addition to the CSA or other form of collateral agreement. Registered funds that do not currently have these agreements in place will likely will be required to negotiate them bilaterally because, as noted above, the ISDA VM Protocol does not include a form of tri-party control agreement or currently accommodate the segregation requirements of registered funds through the “New CSA” method.

Final Thoughts

The March 1, 2017 compliance date for variation margin is fast approaching and we do not expect that this compliance date will be extended. As a result, we recommend that Financial End Users be proactive in reaching out to their Covered Swap Entity counterparties to put in place documentation to ensure that they are not restricted from trading swaps and security-based swaps on and after March 1, 2017.

Willkie would be happy to assist you in addressing all aspects of the new global swap margin rules.

²¹ Ensuring sufficient time for meeting margin calls is a critical point for many firms.

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