

# PREPARING FOR U.S. UNCLEARED SWAP MARGIN RULES



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**U**nder rules recently adopted by the U.S. banking regulators and **Commodity Futures Trading Commission**, registered swap dealers (SDs) will soon need to comply with margin collection, posting, segregation and documentation requirements. SDs that enter into uncleared swaps and—under the banking regulators’ rules—security-based swaps (collectively, “swaps”) will need to engage in extensive preparation during the months leading up to the first compliance deadline, which is Sept. 1, 2016 for the largest counterparty pairs.

SDs must soon develop in-house (or customize to their individual requirements and businesses) policies and procedures and form documents. They also must develop significant compliance processes that fit the individual SD’s compliance program and control infrastructure. Trade association and other industry working groups have launched efforts to help SDs and counterparties with some of the myriad implementation and compliance tasks, including drafting standardized documentation and developing initial margin models. We have marked with an asterisk those tasks that may be aided by these initiatives.

Compounding the compliance challenges facing SDs, the **Securities and Exchange Commission** is developing its own standards for non-bank security-based swap dealers, and foreign regulators (including in the EU, Canada

and Japan) are implementing requirements for uncleared swaps margin subject to their jurisdictions, many of which are not yet finalized as of publication time. As these requirements come on line, affected SDs will need to modify, and likely add to, the task list below.

## COUNTERPARTY CATEGORIZATION

SD collection and posting requirements for initial margin or variation margin depend on whether a counterparty is an SD, a financial end user (FEU) with or without material swaps exposure (MSE) or another type of counterparty (*see box, below*).

In addition, no collection or posting of margin is required for “exempt swaps,” which include, subject to satisfaction of conditions, uncleared swaps entered into for risk-mitigation purposes between an SD and a non-FEU. Special rules apply to swaps with affiliates.

### Compliance tasks

Establish processes for classifying all swap counterparties\* and conduct an initial assessment, or obtain counterparty representations.

Develop processes and systems to determine whether each FEU has MSE, or obtain counterparty representations.

Develop processes to determine when a swap transaction with an end user counterparty is exempt, or obtain counterparty representations.

## ESTABLISHING COMPLIANCE DATES FOR ALL COUNTERPARTIES

Initial margin requirements will be phased in between Sept. 1, 2016 and Sept. 1, 2020, and variation margin requirements will be phased in on Sept. 1, 2016 or March 1, 2017. The applicable compliance date for a given counterparty will depend on the combined average daily aggregate notional amount of uncleared swaps, foreign exchange swaps and foreign exchange forwards (excluding exempt swaps) for March, April and May of a given year for: (i) the SD (and its affiliates) with all counterparties; and (ii) the counterparty (and all of its affiliates) with all counterparties.

Generally speaking, margin requirements apply only to uncleared swap transactions that are entered into on or after the relevant compliance date, subject to an exception described below in the section on eligible master netting agreements (EMNAs) and netting portfolios.

### Compliance tasks

Develop a system to perform the necessary calculations to determine the compliance date for each counterparty.

Identify counterparties that will be subject to the Sept. 1, 2016 deadline and each subsequent compliance deadline.

Communicate with counterparties about the upcoming margin requirements.

Develop processes to obtain notification from counterparties of a change in their status.\*

## INITIAL, VARIATION MARGIN AND COLLECTION

### 1. Determining Initial Margin

#### Models Versus Standardized Method

An SD may calculate minimum initial margin requirements, using either: (i) an initial margin model that must conform to specified requirements and be approved by the relevant regulator; or (ii) a standardized margin table. An SD may adopt a maximum initial margin threshold amount of \$50m for all uncleared swaps between the SD (and its affiliates) and its counterparty (and its affiliates). Special rules apply to swaps with affiliates.

### Compliance tasks

Determine whether to use an initial margin model or standardized approach, or a combination.

SD Counterparty	Initial Margin Requirement	Variation Margin Requirement
SD	Collect <sup>1</sup>	Collect and post
FEU with MSE	Collect and post	Collect and post
FEU without MSE		
SDs that are banks and prudentially regulated by the banking regulators (PR SDs)	Collect as determined appropriate by the PR SD	Collect and post
SDs that are not prudentially regulated (CFTC SDs)	No affirmative requirement	Collect and post
Other counterparty (PR SDs)	Collect as determined appropriate by the PR SD	Collect as determined appropriate by the PR SD
(CFTC SDs)	No affirmative requirement	No affirmative requirement

<sup>1</sup> As a practical matter, swaps between two SDs will require bilateral collecting and posting of initial margin.

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Develop processes to determine the initial margin threshold amount for each counterparty and its affiliates and the allocation of the threshold amount across counterparties' affiliates, and processes for continuing review.

Develop systems to calculate the initial margin collection amount for each swap counterparty.\*

Develop processes to collect and post required margin and flag problems, including: alerts where counterparties do not comply with their posting requirement; pursuit of formal dispute resolution mechanisms; and for documenting a counterparty's refusal or failure to provide the required margin and making appropriate collection efforts.

**Building, Obtaining Approval For Initial Margin Models And Model Governance**

Initial margin models must meet specified criteria and be approved by the relevant regulator. Regulators must be informed of changes.

**Compliance tasks**

Determine whether to use a proprietary or third-party model (such as that being developed by the **International Swaps and Derivatives Association**).\*

Document the model.

Submit the initial margin model to the relevant regulator and obtain approval.

Develop processes to monitor and review periodically initial margin model to ensure continuing compliance.

Develop and maintain an independent risk control unit.

Develop an internal audit function that assesses the controls supporting the initial margin model.

Develop escalation procedures and processes to report to regulators if material problems occur.

**2. Determining Variation Margin**

Variation margin must be calculated daily and be equal to the cumulative mark-to-market change in value to an SD of the uncleared swap minus the variation margin already posted.

**Compliance tasks**

Develop processes to calculate and collect variation margin.

**3. Collection And Posting Of Margin**

Required margin must be collected and posted at least daily. An SD is not required to post or collect margin from or to any individual counterparty unless and until the combined amount of initial and variation margin that must be collected or posted (but not yet exchanged) exceeds \$500,000.

**Compliance tasks**

Ensure compliance with requirements for timely collection and posting.

Develop processes to comply with the limited relief for cross-time zone or late-day transactions.

**EMNAs AND NETTING PORTFOLIOS**

An SD is permitted to net uncleared swaps under an EMNA when using an initial margin model or calculating variation margin requirements, subject to specified requirements. An SD that relies on an EMNA to calculate margin must also conduct a legal review and conclude that the agreement meets applicable requirements.

An EMNA may consist of one or more separate netting portfolios to which collecting and posting of margin applies on an aggregate net basis separate from other swaps. Swaps entered into before the relevant compliance date can be excluded from the margin requirements if they are restricted to EMNAs or separate netting portfolios within EMNAs that do not include post-compliance date swaps.

**Compliance tasks**

Identify existing EMNAs\* and the swaps governed by each.

Develop processes for concluding that the EMNA meets the applicable requirements.

Determine whether (and how) separate netting portfolios will be used.

Develop processes for flagging pre-effective and post-effective date uncleared swaps that are commingled under common EMNAs or netting portfolios and factor results into calculations.

**ELIGIBLE COLLATERAL AND HAIRCUTS**

Only limited types of collateral may be used for required initial and variation margin. Specified haircuts apply to non-cash collateral.

**Compliance tasks**

Amend the credit support agreement as necessary to limit permitted collateral.\*

Develop systems to determine eligible collateral and the relevant haircuts.

Monitor the market value and eligibility of collateral collected and posted.

**COLLATERAL SEGREGATION**

Initial margin posted by an SD must be segregated at a third-party custodian. Subject to an exception for affiliate transactions, an SD must also place the initial margin that it is required to collect from an SD or FEU with MSE at a third-party custodian.

**Compliance tasks**

Develop a list of unaffiliated custodians.

Ensure that any initial margin collateral is placed at an unaffiliated custodian.

Enter into new (or modify existing) custodial agreements with unaffiliated custodians, and conduct legal reviews that the agreement meets required criteria.

**SPECIAL RULES FOR AFFILIATES**

A PR SD does not need to post initial margin with an affiliate but it must calculate the amount of initial margin it would be required to post to its affiliate (if it were not an affiliate) that is an FEU with MSE and provide that calculation to its affiliate daily. A CFTC SD generally must post initial margin to an affiliate that is a PR SD in the amount that such affiliate is required to collect, but is not otherwise required to post initial margin with an affiliate.

A PR SD must collect initial margin from an affiliate that is an SD or FEU with MSE, subject to a \$20m initial margin threshold amount (rather than the combined \$50m threshold for all non-affiliate transactions with a counterparty and its affiliates). With certain exceptions, including for certain foreign affiliates, a CFTC SD is not required to collect initial margin from its affiliates, provided that the uncleared swaps are subject to a centralized risk management program.

An SD that collects non-cash collateral from an affiliate may serve as the custodian, or have the affiliate serve as the custodian, for such collateral.

**Compliance tasks**

Identify and categorize all affiliate counterparties.

For PR SDs, develop processes to assign and monitor the \$20m initial margin threshold for affiliates.

For CFTC SDs, develop processes to determine whether exceptions are met to require initial margin to be collected from affiliates.

**TRADING DOCUMENTATION**

An SD must execute trading documentation with each SD and FEU counterparty that grants the SD the contractual right to collect margin in required amounts, details valuation and other procedures and addresses valuation disputes.

**Compliance tasks**

Develop processes to ensure qualifying trading documentation\* is in place with counterparties.

**CROSS-BORDER ISSUES**

Swaps between a foreign PR SD and foreign counterparties are exempt from the U.S. bank-

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REGULATOR	REGION	TOPIC	DETAILS	DEADLINE
FINRA	North America	Sales on military installations	The SEC has approved FINRA Rule 2272 regarding sales of securities on military installations to military members or their dependents.	Becomes effective March 30.
Chicago Board Options Exchange	North America	Complex orders	Filed with the SEC a proposal related to complex orders.	Comments due March 31.
CFTC	North America	Margin requirements	The CFTC issued final rules on margin requirements for uncleared swaps for swap dealers and major swap participants.	Becomes effective April 1.
Financial Conduct Authority (U.K.)	Europe	Benchmark access	The FCA issued a policy statement and published final rules on non-discriminatory access to regulated benchmarks.	Becomes effective April 1.
FINRA	North America	Settlement cycle	FINRA is seeking comment on a proposal that would support the initiative to shorten the settlement for securities in the U.S. secondary market from trade plus three business days to trade plus two business days.	Comments due April 4.
FINRA	North America	Rules 6191 and 7440	FINRA has proposed a rule change to adopt Rule 6191 and amend Rule 7440 to implement a tick size pilot program.	Implementation date of April 4.
FINRA	North America	Unlisted real estate investment trusts	The SEC has approved amendments to FINRA Rule 2310 and NASD Rule 2340 to modify the requirements relating to the inclusion of per share estimated values for direct participation program and unlisted REIT securities on account statements.	Becomes effective April 11.
Canadian Securities Administrators	North America	Collateral for cleared derivatives	The CSA has proposed requirements for the treatment of customer collateral, recordkeeping and disclosure for clearing intermediaries and regulated clearing agencies providing clearing services for over-the-counter derivatives.	Comments due April 19.
SEC	North America	Security-based swaps	The SEC has issued final rules on security-based swaps transactions connected with a non-U.S. person's dealing activity that are arranged, negotiated or executed by personnel located in a U.S. branch or office or in a U.S. branch or office of an agent.	Becomes effective April 19.

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ing regulators' rules provided that: (i) neither party's obligations under such swaps are guaranteed by a U.S. entity; and (ii) neither the PR SD or foreign counterparty is a subsidiary of a U.S. person.

For swaps not subject to this exemption, substituted compliance may be available in certain cases where the applicable foreign margin regime is determined to be comparable. Partial substituted compliance also may be available to swaps with a counterparty located in a jurisdiction where inherent limitations in the legal or operational infrastructure make it impracticable for the PR SD and counterparty to post initial margin.

As of publication time, the CFTC has not issued final rules addressing the cross-border application of its margin requirements. Qualifying foreign PR SDs will need to complete the following tasks:

**Compliance tasks**

Develop and maintain systems that identify: (i) foreign non-cleared swaps that may be excluded from the minimum margin requirements established under the U.S. banking regulators' rules; and (ii) (where substituted compliance is made available) swaps for which posting and collecting of margin may be conducted in accordance with a comparable foreign regulatory regime.

Compile information necessary to apply for a comparability determination and make such an application to the regulators.

Establish processes for categorizing transactions as foreign non-cleared swaps.

As noted above, when non-U.S. uncleared swap margin regimes (such as the European Market Infrastructure Regulation in the EU) are

fully implemented, SDs operating on a multi-jurisdictional basis will need to modify and expand the list of implementation tasks to take account of overlapping, incremental and potentially duplicative requirements.

**General requirements**

Draft and maintain policies and procedures to describe all processes for complying with the above tasks.

Integrate these into the chief compliance officer report and related processes.

Integrate into existing compliance testing, risk and governance frameworks.

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