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Margin Rules for Uncleared Swaps and Understanding Impact on Documentation

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Regulatory Background

Following the financial crisis, and as a result of the specific commitments to financial reform agreed to at the G-20 Pittsburgh summit, the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) recommended minimum standards for margining non-cleared swaps. In the United States, this requirement to margin non-cleared swaps was included in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). Regulators in the United States and certain other jurisdictions have now published final rules implementing these minimum standards. In the United States, final rules were published in October 2015 for entities subject to the jurisdiction of U.S. prudential regulators, and in December 2015 for entities that are not regulated by a U.S. prudential regulator, but are otherwise subject to the jurisdiction of the U.S. Commodity Futures Trading Commission (CFTC) (together, the "Margin Rules"). The prudential regulators in the United States include the Officer of the Comptroller of the Currency, the Board of Governors of the Federal Reserve, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency. The U.S. Securities Exchange Commission (SEC) has not yet published its final rules for entities that are not regulated by a U.S. prudential regulator or the CFTC but are otherwise subject to SEC jurisdiction, although it is expected to do so in the near future.

For the purposes of this practice note, we will focus solely on the U.S. Margin Rules, although U.S. market participants that trade with banks or swap dealers located in other jurisdictions would do well to be cognizant of issues related to the cross-border effect of potentially overlapping or conflicting regulatory regimes.

Entities in Scope

The Margin Rules impose requirements on the exchange of margin related to non-cleared swaps activities of covered entities, which are, generally, either banks subject to the jurisdiction of a U.S. prudential regulator or swap dealers subject to the jurisdiction of the CFTC (referred to broadly for the purposes of this practice note as "Covered Swap Entities" or "CSEs"). The Margin Rules exempt non-cleared swaps with certain end-user counterparties that qualify for exceptions to, or exemptions from, the mandatory clearing requirement under Dodd-Frank; however, the requirement to exchange margin will impact certain counterparties of CSEs.

Particularly, under the Margin Rules CSEs are required to post and/or collect initial margin and variation margin for non-cleared swaps entered into with other CSEs and with certain large "financial end users" that have "material swaps exposure" (MSE). Initial margin (often referred to in swaps documentation as the "Independent Amount") is collateral posted by one party to another that is intended to secure the potential future exposure that might result from closing out a defaulting counterparty's position under certain market conditions and over a certain period of time.

CSEs are also required to post and/or collect only variation margin (and not initial margin) for non-cleared swaps entered into with financial end users without material swaps exposure. Variation margin is collateral that is posted by one party to another in light of changes to the value of the underlying swap, usually determined by a mark-to-market process for the most commonly traded swaps.

The following table represents the application of the Margin Rules across counterparty pairs:

CSE's counterparty	Initial margin required?	Variation margin required?
CSE	Yes	Yes
Financial end user with MSE	Yes	Yes
Financial end user without MSE	No	Yes
Non-financial end user	No	No

What is a financial end user?

A CSE will need to categorize its counterparties in order to know whether initial margin and variation margin must be exchanged, only variation margin, or neither. As a result, understanding the definition of "financial end user" is critical both for CSEs and their counterparties. A financial end user is, generally, one of the following types of entities:

- banks and depository institutions,
- bank holding companies and their affiliates, including savings and loan equivalents,
- businesses licensed or registered as credit or lending entities,
- broker dealers, securities holding companies and investment advisors,
- money transfer services businesses,
- registered investment companies and private funds,
- commodity pools, commodity pool operators, commodity trading advisors, floor traders, introducing brokers and futures commission merchants,
- certain employee benefit plans,
- insurance companies, and
- entities that, or hold themselves out as entities that, raise money from investors, accept money from clients or use proprietary money primarily for investing, trading or facilitating investing or trading in loans, securities, swaps, funds or other assets.

As the enumerated list makes clear, financial end users encompass a broad range of participants in the financial sector. These entities will, at a minimum, be subject to the variation margin requirements under the Margin Rules, to the extent they trade swaps with CSEs.

What is material swaps exposure?

Material swaps exposure exists if, as of the applicable compliance date (see Compliance Phase-In Timeline below), the average daily aggregate notional amount of non-cleared swaps, non-cleared security-based swaps, foreign exchange (FX) forwards and FX swaps (Covered Swaps) that an entity and its affiliates have with all counterparties, for June, July and August of the prior calendar year, exceeds $8 billion.

This calculation may be complicated for many financial end users to operationalize. Because CSEs will need to know how to categorize their financial end user counterparties for the purpose of determining the applicable Margin Rules and compliance dates, financial end users can expect to be asked to make representations to their CSE counterparties as to whether they exceed the MSE threshold.

Compliance Phase-In Timeline

As noted, the Margin Rules related to the posting and collection of variation margin apply to non-cleared derivatives trades between a CSE and a financial end user. Further, the requirement to exchange of variation margin will be phased in over two dates. As of July 2016, the first compliance date begins September 1, 2016 and covers swaps where (i) the CSE and all of its affiliates and (ii) its financial end user counterparty and all of its affiliates, each have an average aggregate daily notional amount of Covered Swaps for March, April and May of 2016 that exceeds $3 trillion. The second compliance date begins March 1, 2017 and covers swaps between any CSE and any other financial end user. European authorities have recently delayed these compliance dates for the margin rules coming into force in the European Union, so there is some possibility that the U.S. prudential regulators and the CFTC will likewise delay these compliance dates, although that is uncertain.

Initial margin requirements are subject to a separate four-year phase-in based on a similar calculation of Covered Swaps. In general, however, the initial margin rules will not apply until 2019 or 2020, except for the very largest financial end users.

Impact of Variation Margin Rules on Existing Swap Documentation

As a result of the quickly approaching dates for complying with the Margin Rules as they relate to the required exchange of variation margin, on April 13, 2016, the International Swaps and Derivatives Association, Inc. (ISDA) published an updated version of Credit Support Annex (CSA) to facilitate compliance by market participants with new requirements governing the exchange of variation margin applicable to non-cleared swaps. The new CSA, entitled the 2016 Credit Support Annex for Variation Margin (NY Law) (2016 VM CSA (NY)), is intended for use with New York law ISDA Master Agreements. In the near future ISDA will also be publishing a similarly

updated New York law CSA in order to comply with upcoming initial margin requirements. The 2016 VM CSA (NY) only addresses variation margin and because it contemplates the use of a separate CSA to govern any applicable initial margin requirements, significant changes have been made to ISDA's existing form of CSA in order to reflect the bifurcation of variation margin and initial margin.

Consequently, financial end users will need to assess their existing credit support documentation for swaps against the 2016 VM CSA (NY), which complies with the Margin Rules.

The following table highlights the main differences between ISDA's existing CSA and the new 2016 VM CSA (NY) that CSEs and financial end users will need to implement:

Issue	Existing CSAs	2016 VM CSA (NY)
Transaction scope and netting sets	Generally all transactions under an ISDA Master Agreement are covered unless specific transactions are carved out. A single CSA covers both initial margin and variation margin. All trades under the ISDA Master Agreement constitute a "netting set" for the purposes of determining net exposure.	"Covered Transactions" is to be defined by the parties and are the only transactions relevant for determining net exposure. Other CSAs are amended to exclude any Covered Transactions. Will not cover legacy trades prior to a date specified by the parties, unless the parties agree that legacy trades are to be "Covered Transactions" and thus netted against non-legacy trades. Therefore legacy trades may not be netted against non-legacy trades for purposes of determining the variation margin to be transferred or returned. Unless otherwise agreed by the parties, "Covered Transactions" are not required to include physically-settled FX forwards and FX swaps, which are not subject to the Margin Rules. Hence if the parties wish to margin physically-settled FX forwards and FX swaps on a contractually agreed basis that differs from the Margin Rules, a separate netting set would need to be created for these trades.
Scope of collateralization	Initial margin held or pledged is generally incorporated in the determination of the margin to be transferred or returned. The parties may agree to a "threshold amount" which is the amount of unsecured exposure a party is willing to take before requiring collateralization.	Only variation margin is incorporated in the determination of margin to be transferred or returned; initial margin held or pledged is not relevant. There is no threshold amount applicable for variation margin.
Minimum transfer amounts	Any amount, as agreed between the parties; $250,000 or $500,000 is not uncommon for financial end users facing CSEs.	Can be any amount agreed between the parties, up to a maximum of $500,000 as required by the Margin Rules, applied to initial margin and variation margin in the aggregate.

Eligible collateral	As agreed between the parties; many CSAs specify eligible collateral that is similar to, but does not align exactly with, the eligibility requirements of the Margin Rules; some CSAs also have significantly bespoke collateral eligibility lists.	Two ways that parties can restrict collateral eligibility to comply with Margin Rules: (1) the parties may describe any conditions to eligibility, e.g. ratings requirements or concentration limits; and/or (2) unless otherwise specified, upon delivery by the secured party of a "Legal Ineligibility Notice" each item of eligible collateral (or a specified amount of such item) ceases to be eligible as of a specified date. The Legal Ineligibility Notice is a notice in which secured party represents that it has determined that the item (or an amount of the item) has ceased or will cease to satisfy collateral eligibility requirements as of a specified date. A minimum of five local business days following date of delivery of the notice applies before the collateral is deemed ineligible. The pledgor can request reconsideration.
Valuation of collateral and haircuts	As agreed between the parties; many CSAs have valuation percentages that are similar to, but do not align exactly with, the percentages required under the Margin Rules; some CSAs also have significantly bespoke valuation percentages.	Valuation percentage is 100% unless specified otherwise by the parties, and subject to a maximum valuation percentage that is permitted by the Margin Rules. Cross-currency haircut of 8% applies, unless the margin is in the form of cash denominated in a specified major currency, or non-cash collateral denominated in specified eligible currency, which under Margin Rules must match the currency of settlement of transaction.
Time by which collateral must be transferred or returned	Before notification time: by close of business on the next local business day; after the notification time: by close of business on the second local business day. Some parties agree to shorten this timing by a day. Notification time defaults to1:00 pm on New York time although many parties modify this to 10:00 am New York time.	Shortened by a day, such that before notification time: by close of business on the same local business day; after the notification time: by close of business on the next local business day. Notification time defaults to 10:00 am New York time unless agreed otherwise by the parties. Includes technical and likely non-controversial changes to the definition of local business day.

Transfer of interest on posted collateral and treatment of negative interest	Often modified by parties. Transfer of interest was made as agreed at the times specified by the parties. Not uncommon to specify that the transfer of interest would be monthly. Parties could also elect to have interest amount, to the extent payable, become part of posted collateral if a transfer would otherwise result in a requirement to deliver margin. Treatment of negative rates is unclear; the ISDA 2014 Collateral Agreement Negative Interest Protocol provides market participants with certainty by incorporating the pass through of negative interest on posted collateral. Some market participants amend CSAs to incorporate the protocol or to include a floor, i.e. any negative interest amounts are deemed to be equal to zero.	Allows for similar methods for treatment of interest, with clarifications as to how negative interest may be treated. Sets out clearer set of elections by the parties in order to address negative interest rates.
Offset of credit support due under other CSAs	Multiple CSAs are not contemplated.	Multiple CSAs are contemplated; therefore allows the parties to elect to offset opposite flows of variation margin and any unsegregated initial margin that is not required under the Margin Rules. Cannot offset any variation margin against any transfer of segregated initial margin that is required under the Margin Rules.
Right to set-off credit support posted under another CSA after the occurrence of an event of default, specified condition or early termination date (with respect to pledgor) or an early termination date (with respect to secured party).	Multiple CSAs are not contemplated.	Permits two-way (mutual) set-off against any initial margin or variation margin posted under any other CSA, if such set-off is not prohibited under the other CSA.
Dispute resolution timing	Disputing party must notify the other party by no later than close of business on the local business day following the date demand for collateral is made (if disputing secured party's exposure) or the date of transfer of collateral (if disputing value of collateral).	Disputing party must notify the other party not later than close of business on the same date the transfer of collateral is due (if disputing secured party's exposure) or by the local business day following the date of transfer of collateral (if disputing value of collateral).

Means of Compliance

In order to comply with the variation margin requirement under the Margin Rules, a CSE will ask its financial end user counterparties to amend existing CSAs, execute entirely new CSAs, or enter into an ISDA Protocol. An ISDA Protocol is a multilateral agreement that allows for standardized amendments to be made to the relevant documentation between any two parties that adhere to the protocol. Given the sheer volume of documentation changes that will need to be made to existing credit support documentation, the general expectation is that most counterparties will utilize the ISDA Protocol as a means of complying with the Margin Rules.

ISDA is in the process of developing a protocol that will allow market participants to (i) execute a regulatory compliant 2016 VM CSA (NY) or (ii) update their existing CSAs to comply with the regulatory compliant 2016 VM CSA (NY). As in existing CSAs, parties will also need to make certain elections for variable terms, such as specifying eligible collateral, haircuts or transfer timing (other than what

may be required as a minimum under the Margin Rules) or describing any conditions on collateral eligibility. Under the protocol, there will be three methods for creating compliant documentation:

"Amend" – under this method, terms in existing CSAs will be amended as needed in order to comply with the Margin Rules. All trades, including legacy trades will be covered by a single, regulatory compliant 2016 VM CSA (NY).

"Replicate and amend" – under this method, a "duplicate" CSA is created from existing CSAs between the parties, and then amended only as needed in order to comply with the Margin Rules. This carves out legacy trades so that only new trades are subject to the regulatory compliant 2016 VM CSA (NY).

"New CSA" – under this method, the parties enter into an entirely new CSA from scratch, as it were. Legacy trades are carved out so that only new trades are subject to the new, regulatory compliant 2016 VM CSA (NY).

Given the complexity of the Margin Rules, the upcoming ISDA Protocol, and the number of documentation and operational initiatives that will need to be undertaken not just by CSEs but also by financial end users, market participants would do well to begin considering the forthcoming impact of the Margin Rules on their swap trading activity.

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