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Highlights of Final Prudential Regulator Margin Rules for Non-Cleared Swaps

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The US prudential regulators (the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve, the Comptroller of the Currency, the Farm Credit Administration and the Federal Housing Finance Agency) have each adopted (1) a final margin rule, and (2) an interim final margin rule (collectively, the "Rules") that set mandatory margin requirements for swap dealers, security-based swap dealers, major swap participants and major security-based swap participants (each, a "Swap Entity" or SE) that are regulated by those agencies (each, a "Covered Swap Entity" or CSE).[1] The Rules apply to any swap or security-based swap of a CSE that is not cleared with a derivatives clearing organization or clearing agency.

The Rules are generally similar to the rules proposed by the prudential regulators last year and are consistent with the international standards for non-cleared swap margin published by the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions in September 2013 (the "International Standards"). The ***Commodity Futures Trading Commission (CFTC)*** and the ***Securities and Exchange Commission (SEC)*** have not yet issued final margin rules for non-cleared swaps that would apply to the Swap Entities they regulate, but those rules are expected to be quite similar.

HIGHLIGHTS

1. The margin requirements for a particular non-cleared swap or security-based swap are determined by the regulatory categorization of the two counterparties (see Exhibit A).
    1. If the transaction is between (1) two CSEs, (2) a CSE and a Swap Entity, or (3) a Covered Swap Entity and a "financial end user" with "material swaps exposure", there are mandatory initial margin (IM) and variation margin (VM) requirements. (See Exhibit B for the definition of "financial end user.")

2. If the transaction is between a Covered Swap Entity and a financial end user that does not have a material swaps exposure, VM applies, but not IM.

2. "Material swaps exposure" for a financial end user means that the entity and its affiliates have an average daily aggregate notional amount of non-cleared swaps, non-cleared security-based swaps, foreign exchange forwards and foreign exchange swaps ("Included Transactions") with all counterparties for June, July and August of the previous calendar year that exceeds $8 billion, where such amount is calculated only for business days. (Because there is no exemption in this definition for counting transactions of a Swap Entity, any financial end user that is affiliated with a Swap Entity is highly likely to have a material swaps exposure on an aggregate basis.)

3. There are no mandatory margin requirements for any other pairs of counterparties, but a Covered Swap Entity facing a counterparty other than an SE or a financial end user is required to collect IM and VM "at such times and in such forms and amounts (if any) that it determines will appropriately address the credit risk of the counterparty." As a result of this requirement, if an SE currently has contractual margin requirements in place with a counterparty, it will undoubtedly keep them in place after the Rules go into effect. However, any margin agreed contractually by the parties does not have to conform to the Rules.

4. IM must be calculated using percentages in a table in the Rules or using an internal risk management model approved in writing by the CSE's prudential regulator. IM is subject to a $50 million posting threshold (applied on a group-to-group basis rather than counterparty-to-counterparty basis) and there is a $500,000 minimum transfer amount (for IM and VM combined). IM must be segregated with an independent custodian. Eligible collateral for IM includes cash and numerous other assets subject to prescribed haircuts. The International Swaps and Derivatives Association (ISDA) is working on a standard IM model that can be used by all market participants to avoid an obvious source of disputes.

5. The Rules do not prescribe a methodology for calculating VM, so a CSE can use existing models to calculate the daily mark-to-market change in the value of a relevant transaction. The threshold for posting VM is zero, but there is a $500,000 minimum transfer amount (for IM and VM combined). VM does not need to be segregated. Only cash is eligible collateral for VM between two CSEs or between a CSE and a Swap Entity, but the same assets that are eligible collateral for IM can be used for VM between a CSE and a financial end user.

6. All non-cleared swaps that are exempt from mandatory clearing due to a statutory or regulatory exception or exemption (such as those for non-financial end users, captive finance companies, small financial institutions with less than $10 billion in total assets and cooperatives) are exempt from the Rules as required by Title III of the Terrorism Risk Insurance Program Reauthorization Act of 2015 (which amended Sections 731 and 764 of the Dodd-Frank Act). In addition, the Rules do not apply to a swap if it is not yet subject to mandatory clearing but would be covered by such an exemption if it was.

7. The Rules apply to non-cleared swaps between affiliates (defined by reference to consolidation in financial statements rather than by voting control), but they specify that (a) such swaps need only be counted once in calculating aggregate group transaction activity, (b) each affiliate may be granted a separate margin threshold of $20 million, (c) a CSE does not have to post IM to an affiliate, (d) non-cash IM from an affiliate can be held by a CSE or an affiliated custodian, and (e) the exposure on some affiliate swaps can be modeled using a

shorter assumed holding period.

8. The Rules grandfather the margin treatment of pre-compliance date swaps if they are documented in a different master agreement from post-compliance date swaps. There is, however, a provision in the Rules that was not in the original proposal from the regulators that says that pre- and post-compliance date swaps can be treated separately even if they are in the same master agreement if they are contained in separate "netting portfolios that independently meet the . . . the definition of eligible master netting agreement." Further study will be required to determine if it is possible for a single document to meet that standard given that the definition of eligible master netting agreement requires CSEs to have a "well-founded basis" that the agreement will be enforceable.

9. The Rules contain specific documentation requirements, so all current margin agreements will have to be amended to conform to the Rules and margin provisions must be added to swap agreements between SEs and financial end users that do not currently have them. ISDA is expected to publish standardized documents and protocols to assist with this effort.

COMPLIANCE DATES

The effective date of the Rules is April 1, 2016, but there are various compliance dates for CSEs based on the level of market activity of the counterparties to a swap in order to allow for a phased implementation. The market activity threshold for any compliance date is calculated on an aggregate basis for each counterparty and all of its affiliates, and both parties must exceed the threshold before the relevant compliance date applies. Once a CSE has identified a compliance date that is applicable to its swaps with another party, the Rules apply thereafter even if the market activity of one or both parties subsequently falls below the threshold applicable in a later year.

1. Compliance Dates for VM

Counterparty 1 = CSE	**Counterparty 2 = CSE, SE or Financial End User**	**Compliance Date**
Average daily aggregate notional amount of Included Transactions for March, April and May of 2016 that **exceeds $3 trillion**.	Average daily aggregate notional amount of Included Transactions for March, April and May of 2016 that **exceeds $3 trillion**.	September 1, 2016
Average daily aggregate notional amount of Included Transactions for March, April and May of 2016 **equal to or less than $3 trillion.**	Average daily aggregate notional amount of Included Transactions for March, April and May of 2016 **equal to or less than $3 trillion**.	March 1, 2017 This is likely to be the starting date for VM for most CSEs, SEs and financial end users.

2. Compliance Dates for IM

Counterparty 1 = CSE	**Counterparty 2 = CSE, SE or Financial End User with material swaps exposure**	**Compliance Date**

Average daily aggregate notional amount of Included Transactions for March, April and May of 2016 that **exceeds $3 trillion**.	Average daily aggregate notional amount of Included Transactions for March, April and May of 2016 that **exceeds $3 trillion**.	September 1, 2016
Average daily aggregate notional amount of Included Transactions for March, April and May of 2017 **equal to or less than $3 trillion but greater than $2.25 trillion.**	Average daily aggregate notional amount of Included Transactions for March, April and May of 2017 **equal to or less than $3 trillion but greater than $2.25 trillion.**	September 1, 2017
Average daily aggregate notional amount of Included Transactions for March, April and May of 2018 **equal to or less than $2.25 trillion but greater than $1.5 trillion.**	Average daily aggregate notional amount of Included Transactions for March, April and May of 2018 **equal to or less than $2.25 trillion but greater than $1.5 trillion.**	September 1, 2018
Average daily aggregate notional amount of Included Transactions for March, April and May of 2019 **equal to or less than $1.5 trillion but greater than $.75 trillion.**	Average daily aggregate notional amount of Included Transactions for March, April and May of 2019 **equal to or less than $1.5 trillion but greater than $.75 trillion.**	September 1, 2019
Not subject to an earlier compliance date.	Not subject to an earlier compliance date.	September 1, 2020 This is likely to be the starting date for IM for any CSE, SE or financial end user with material swaps exposure that has an aggregate portfolio of Included Transactions for 2016 that is less than or equal to $.75 trillion.

RECOMMENDED ACTIONS

1. Every participant in the derivatives markets that is not an SE should determine if it is a financial end user.

2. Every SE and financial end user should identify all its affiliates for purposes of the Rules based on the definition that a company is an affiliate of another company if:

    1. either company consolidates the other on financial statements prepared in accordance with US Generally Accepted Accounting Principles, the International Financial Reporting Standards, or other similar standards;

    2. both companies are consolidated with a third company on a financial statement

prepared in accordance with such principles or standards; or

3. for a company that is not subject to such principles or standards, if consolidation as described in paragraph (a) or (b) of this definition would have occurred if such principles or standards had applied.

3. Every SE should calculate its current aggregate portfolio of Included Transactions in order to estimate the compliance date that could be applicable to it.

4. Every financial end user should calculate its current aggregate portfolio of Included Transactions in order to estimate (a) if it has material swaps exposure, and (b) the compliance date that could be applicable to it.

5. Every CSE and financial end user should review its swap documentation and begin to discuss required changes with relevant counterparties..

EXHIBIT A

Final Prudential Regulator Margin Rules for Non-cleared Swaps

This table summarizes the initial margin (IM) and variation margin (VM) requirements applicable to non-cleared swaps that were issued in October 2015 by US prudential regulators in the form of (1) a final margin rule, and (2) an interim final rule (collectively, the "Rules"). This table shows the margin requirements for various pairs of swap counterparties after the Rules are fully in effect. Terms used in the table are defined below the table.

Party A	**Party B**			
	Swap Entity	**Financial End User with Material Swaps Exposure**	**Other Financial End User**	**End User**
Swap Entity	Mandatory IM and VM for both parties (each Swap Entity calculates the IM it collects)	Mandatory IM and VM for both parties (Swap Entity calculates the IM for both parties)	Mandatory VM but not IM (but Swap Entity must collect IM to extent it deems appropriate to mitigate counterparty credit risk)	No Mandatory I or VM (but Swap Entity must collect IM and/or VM to extent it deems appropriate to mitigate counterparty cre risk)
Financial End User with Material Swaps Exposure	Mandatory IM and VM for both parties (Swap Entity calculates the IM for both parties)	No Mandatory IM or VM	No Mandatory IM or VM	No Mandatory I or VM
Other Financial End User	Mandatory VM but not IM (but Swap	No Mandatory IM or VM	No Mandatory IM or VM	No Mandatory I or VM

	Entity must collect IM to extent it deems appropriate to mitigate counterparty credit risk)			
End User	No Mandatory IM or VM (but Swap Entity must collect IM and/or VM to extent it deems appropriate to mitigate counterparty credit risk)	No Mandatory IM or VM	No Mandatory IM or VM	No Mandatory I or VM

For the purposes of this table:

- "Swap Entity" means a swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant.
- "Financial End User" (or FEU) has the meaning assigned to that term in the Rules.
- "End User" means any party other than a Swap Entity or an FEU.
- "Material Swaps Exposure" means, with respect to any entity, that the entity and its affiliates have an average daily aggregate notional amount of non-cleared swaps, non-cleared security-based swaps, foreign exchange forwards and foreign exchange swaps with all counterparties for June, July and August of the previous calendar year that exceeds $8 billion, where such amount is calculated only for business days.

EXHIBIT B

"Financial End User" means any party to a derivative that is not a Swap Entity but is:

1. A bank holding company or an affiliate thereof; a savings and loan holding company; a U.S. intermediate holding company established or designated for purposes of compliance with 12 CFR 252.153; or a nonbank financial institution supervised by the Board of Governors of the Federal Reserve System under Title I of the Dodd-Frank Wall Street Reform and Consumer Protection Act (12 U.S.C. 5323);

2. A depository institution; a foreign bank; a federal credit union or State credit union as defined in Section 2 of the Federal Credit Union Act (12 U.S.C. 1752(1) & (6)); an institution that functions solely in a trust or fiduciary capacity as described in Section 2(c)(2)(D) of the Bank Holding Company Act (12 U.S.C. 1841(c)(2)(D)); an industrial loan company, an industrial bank, or other similar institution described in Section 2(c)(2)(H) of the Bank Holding Company Act (12 U.S.C. 1841(c)(2)(H));

3. An entity that is state-licensed or registered as:

    1. a credit or lending entity, including a finance company; money lender; installment lender; consumer lender or lending company; mortgage lender, broker, or bank; motor vehicle title pledge lender; payday or deferred deposit lender; premium finance company; commercial finance or lending company; or commercial mortgage company; but excluding entities registered or licensed solely on account of financing the entity's direct sales of goods or services to customers;

    2. a money services business, including a check casher; money transmitter; currency dealer or exchange; or money order or traveler's check issuer;

4. A regulated entity as defined in Section 1303(20) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 U.S.C. 4502(20)) and any entity for which the Federal Housing Finance Agency or its successor is the primary federal regulator;

5. Any institution chartered in accordance with the Farm Credit Act of 1971, as amended, 12 U.S.C. § 2001 et seq., that is regulated by the Farm Credit Administration;

6. A securities holding company; a broker or dealer; an investment adviser as defined in Section 202(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)); an investment company registered with the SEC under the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.); or a company that has elected to be regulated as a business development company pursuant to Section 54(a) of the Investment Company (15 U.S.C. 80a-53(a));

7. A private fund as defined in Section 202(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80-b-2(a)); an entity that would be an investment company under Section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a-3) but for Section 3(c)(5)(C); or an entity that is deemed not to be an investment company under Section 3 of the Investment Company Act of 1940 pursuant to Investment Company Act Rule 3a-7 (17 CFR 270.3a-7) of the Securities and Exchange Commission;

8. A commodity pool, a commodity pool operator, or a commodity trading advisor as defined in, respectively, Sections 1a(10), 1a(11), and 1a(12) of the Commodity Exchange Act (7 U.S.C. 1a(10), 7 U.S.C. 1a(11), 7 U.S.C. 1a(12)); a floor broker, a floor trader, or introducing broker as defined, respectively, in 1a(22), 1a(23) and 1a(31) of the Commodity Exchange Act of 1936 (7 U.S.C. 1a(22), 1a(23), and 1a(31)); or a futures commission merchant as defined in 1a(28) of the Commodity Exchange Act (7 U.S.C. 1a(28));

9. An employee benefit plan as defined in paragraphs (3) and (32) of Section 3 of the Employee Retirement Income and Security Act of 1974 (29 U.S.C. 1002);

10. An entity that is organized as an insurance company, primarily engaged in writing insurance or reinsuring risks underwritten by insurance companies, or is subject to supervision as such by a State insurance regulator or foreign insurance regulator;

11. An entity, person, or arrangement that is, or holds itself out as being, an entity, person, or arrangement that raises money from investors, accepts money from clients, or uses its own money primarily for the purpose of investing or trading or facilitating the investing or trading in loans, securities, swaps, funds or other assets for resale or other disposition or otherwise

trading in loans, securities, swaps, funds or other assets; or

12. An entity that would be a financial end user as described above if it were organized under the laws of the United States or any state thereof.

The term "financial end user" does not include any counterparty that is:

- A sovereign entity;
- A multilateral development bank [as defined in the Rules];
- The Bank for International Settlements;
- A captive finance company that qualifies for the exemption from the definition of financial entity pursuant to Section 2(h)(7)(C)(iii) of the Commodity Exchange Act and implementing regulations; or
- An affiliate that qualifies for the exemption from clearing pursuant to Section 2(h)(7)(D) of the Commodity Exchange Act or Section 3C(g)(4) of the Securities Exchange Act and implementing regulations.

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[1] The text of the Rules can be found here. A press release concerning the issuance of the Rules can be found here

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