

Proposed Margin Requirements for Uncleared Swaps Could Significantly Increase the Costs Associated with Over-the-Counter Swap Transactions and May Apply to Some End-Users

April 13, 2011

Yesterday the Commodity Futures Trading Commission (CFTC) and certain Federal bank regulators issued proposed margin requirements for uncleared swaps, as required by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act). The margin requirements contained in the proposal issued by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency (collectively referred to as the Prudential Regulators) will apply to those entities that are swap dealers, security-based swap dealers, major swap participants or major security-based swap participants¹ under Title VII of the Dodd-Frank Act and that are currently regulated by one of the Prudential Regulators. The CFTC's proposal, on the other hand, will apply to those swap dealers and major swap participants that are not currently regulated by a Prudential Regulator.

The Securities and Exchange Commission has not yet issued proposed margin requirements for security-based swap dealers and major security-based swap participants that are not currently regulated by a Prudential Regulator. A pre-publication copy of the joint proposal issued by the Prudential Regulators is available [here](#). The CFTC has released a [Fact Sheet](#) and a [Q&A](#) addressing its proposed margin requirements, but not the full text of its proposal.

The Dodd-Frank Act requires many swaps that are currently executed in the over-the-counter market to be cleared through derivatives clearing organizations. However, for those swaps that will continue to be transacted in the over-the-counter market, the proposed margin requirements issued yesterday mark a significant departure from current practices. Specifically, with certain exceptions, including a limited exception for swaps entered into between non-financial end-users and non-bank swap dealers or major swap participants, market participants would be required to post both initial margin and variation margin to their swap dealer and major swap participant counterparties.

Both the Prudential Regulators' proposal and the CFTC's proposal address: (1) which uncleared swaps will be subject to margin requirements; (2) which entities will be subject to margin requirements for their uncleared swaps; (3) how initial margin and variation margin will be calculated; (4) segregation requirements and investment restrictions for initial margin and variation margin; and (5) the types of collateral that may be accepted as initial margin and variation margin. The Prudential Regulators' proposal also addresses capital requirements for those swap dealers and major swap participants that are regulated by a Prudential Regulator. These capital requirements essentially incorporate by reference the capital requirements that the Prudential Regulators already impose on the entities that they regulate.

¹ The definitions of "swap dealer," "security-based swap dealer," "major swap participant," and "major security-based swap participant" under the Dodd-Frank Act have not been finalized. The CFTC and the SEC issued a joint proposed rule regarding the definitions of these terms in December 2010 but have not yet issued a final rule.

The CFTC's proposal does not include capital requirements, but the CFTC is expected to issue a separate proposal addressing capital requirements in the next few weeks.

The margin requirements set forth in both the CFTC's proposal and the Prudential Regulators' proposal would only apply to swaps entered into after the effective date of the final margin requirements. With respect to which entities would be subject to margin requirements for their uncleared swaps and how such margin would be calculated, both proposals divide counterparties of swap dealers and major swap participants into three categories: (1) other swap dealers and major swap participants; (2) financial entity end-users (which include banks, insurance companies, hedge funds and other entities that engage in activities that are "financial in nature"); and (3) non-financial entity end-users. The Prudential Regulators' proposal sets forth the amounts and types of margin that swap dealers and major swap participants that are regulated by a Prudential Regulator would be required to collect from their counterparties based on the category into which such counterparties fall. The CFTC's proposal sets forth the amounts and types of margin that swap dealers and major swap participants that are not regulated by a Prudential Regulator would be required to collect from their counterparties, also based on the category into which such counterparties fall. Note that neither proposal requires swap dealers and major swap participants to post margin to any of their end-user counterparties, including financial entity end-users such as insurance companies and banks. However, the Prudential Regulators' proposal contains supplemental requirements for institutions regulated by the Farm Credit System and the Federal Housing Finance Agency. These institutions will be required to collect margin from their swap dealer and major swap participant counterparties regardless of whether the institutions themselves are swap dealers or major swap participants.

Based on discussion at yesterday's CFTC meeting and the pre-publication copy of the Prudential Regulators' proposal, the proposed margin requirements would function as follows:

Other swap dealers and major swap participants. Swap dealers and major swap participants that enter into swaps with other swap dealers and major swap participants would be required to both post and collect initial margin and variation margin when they enter into swaps with their swap dealer and major swap participant counterparties, without any thresholds. The initial margin and the variation margin must consist of cash and treasuries (and initial margin may also consist of securities issued by certain government-sponsored enterprises (GSEs)) and initial margin must be held by an independent third-party custodian. Under the CFTC's proposal, variation margin must also be held by an independent third-party custodian. The proposals contain standards for calculating the initial margin that swap dealers and major swap participants would be required to post to, and collect from, each other. It appears that these rules would significantly increase the hedging costs of swap dealers because swap dealers have not heretofore been required to post initial margin to other swap dealers. Moreover, we understand that any margin posted between swap dealers has typically been subject to full rehypothecation rights. The requirement that initial margin be held with an independent custodian could therefore significantly change the economics of swap dealers.

Financial entity end-users. Swap dealers and major swap participants would be required to collect but not post both initial margin and variation margin when they enter into swaps with financial entities.² “Financial entity” is defined in the same way that it is defined for purposes of the end-user clearing exception in Section 2(h)(7) of the Commodity Exchange Act (as amended by the Dodd-Frank Act). Thus, financial entities include banks that are not swap dealers or major swap participants, as well as insurance companies and hedge funds. Thresholds would be permitted for those financial entities (1) that are subject to capital requirements set by a bank or insurance regulators, (2) whose swap portfolios are below certain levels, and (3) that primarily enter into swaps to hedge or mitigate risk. The initial margin and variation margin that swap dealers and major swap participants collect from financial entities must consist of cash and treasuries (and initial margin may also consist of certain GSE securities). Financial entities would have the option of requiring their swap dealer and major swap participant counterparties to segregate the initial margin that the financial entities post to the swap dealers or major swap participants with an independent third-party custodian.

Non-financial end-users. The CFTC’s proposal requires a negotiated credit support arrangement for swaps between swap dealers or major swap participants and non-financial entities but does not explicitly require that initial margin or variation margin be posted or collected for swaps between these counterparties. The CFTC’s proposal does not impose any limits on the types of collateral that a non-financial entity end-user may post to its swap dealer or major swap participant counterparties. The Prudential Regulators’ proposal, on the other hand, requires that swap dealers and major swap participants collect but not post initial margin and variation margin when they enter into swaps with non-financial entity end-users based on “credit exposure limits” set by the swap dealer or major swap participant. Under both proposals, non-financial entity end-users would have the option of requiring their swap dealer and major swap participant counterparties to segregate the initial margin that the non-financial entity end-users post to the swap dealers or major swap participants with an independent third-party custodian. Depending on how the “credit exposure limits” are applied, the Prudential Regulators’ proposal could be viewed as a defeat for end-users that sought a complete exemption from margin requirements for uncleared swaps.

Both the CFTC’s proposal and the Prudential Regulators’ proposal will be published in the Federal Register for public comment within the next few weeks. The CFTC has announced that the comment period for its proposal will extend until at least the end of the comment period for the capital requirements that the CFTC expects to propose before the end of this month. Comments to the Prudential Regulators’ proposal are due on June 24, 2011.



If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

James M. Cain

202.383.0180

james.cain@sutherland.com

² However, as discussed above, financial entities that are regulated by the Farm Credit Administration or the Federal Housing Finance Agency will be required to collect initial and variation margin from their swap dealer and major swap participant counterparties.

Paul B. Turner	713.470.6105
Catherine M. Krupka	202.383.0248
Warren N. Davis	202.383.0133
William H. Hope II	404.853.8103
Mark D. Sherrill	202.383.0360
Ann M. Battle	202.383.0842
Michael W. Brooks	202.383.0863
Doyle Campbell	212.389.5073
Meltem F. Kodaman	202.383.0674
Raymond A. Ramirez	202.383.0868

paul.turner@sutherland.com
catherine.krupka@sutherland.com
warren.davis@sutherland.com
william.hope@sutherland.com
mark.sherrill@sutherland.com
ann.battle@sutherland.com
michael.brooks@sutherland.com
doyle.campbell@sutherland.com
meltem.kodaman@sutherland.com
ray.ramirez@sutherland.com