Securities Regulation Daily Wrap Up, TOP STORY—CFTC adopts final rules on margin for uncleared swaps, (Dec. 16, 2015)

Securities Regulation Daily Wrap Up

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The CFTC adopted final rules imposing margin requirements for swaps transactions that are not cleared through central counterparties. The rules implement Section 4s(e) of the Commodity Exchange Act and apply to swap dealers (SDs) and major swap participants (MSPs) that are not regulated by U.S. banking regulators. According to the CFTC, the rules are very similar to rules on uncleared swaps margin recently adopted by the banking regulators. The rules do not require margin for commercial end users and impose different requirements depending whether a swap is between SDs/MSPs or financial end users. They also provide certain exemptions for swaps between affiliated entities. The new requirements will be phased in starting September 1, 2016, with later deadlines for smaller market participants.

The final rules were approved by a 2-1 vote, with Chairman Timothy Massad and Commissioner J. Christopher Giancarlo voting in support. Commissioner Sharon Bowen dissented, citing concerns over the treatment of inter-affiliate swaps.

Margin requirements. Due to liquidity and other characteristics, not all swaps are required to be centrally cleared. The new margin requirements apply to uncleared swaps and are intended to provide collateral to cover counterparty credit risk as well as reduce firms' ability to take on excessive risk. The rules apply to covered swap entities (CSEs), which are SDs and MSPs that are not subject to oversight by the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration, or the Federal Housing Finance Agency.

The rules impose different margin requirements depending on type of margin and type of entity:

- There are no margin requirements for commercial end users.
- For initial margin, which protects against potential future loss on a default, the rules require daily two-way margin (posting and collecting) for all trades between CSEs and SDs/MSPs. Daily two-way margin is required for all trades between financial end users that have over $8 billion in gross notional exposure in uncleared swaps.
- For variation margin, which acts as mark-to-market protection, the rules require daily cash payment for all trades between CSEs and SD/MSPs, and daily posting for all trades between SD/MSPs and financial end users.

Calculation and collateral. The rules permit for initial margin to be calculated based on models or a standardized table, and allow for a $50 million threshold below which margin does need to be collected. Models need to use a 99% confidence level over 10-day liquidation time. For variation margin, methods and inputs must rely on recent trades or third-party valuations.

Initial margin must be held at an independent custodian, and may not be rehypothecated. Permitted collateral for initial margin includes cash, sovereign debt, government-sponsored debt, investment grade debt including corporate bonds, equities, gold, and shares of certain funds with appropriate haircuts. The same collateral is allowed for variation margin for trades between SD/MSPs and financial end users. For trades between CSEs and SD/MSPs, variation margin must be in cash.

Inter-affiliate exemption. Apart from initial margin on certain inter-affiliate swap transactions to prevent evasion and other exceptions, inter-affiliate swaps are exempted from initial margin requirements. However, variation margin must still be exchanged.

In voting against the final rule, Commissioner Bowen disapproved of the exemption for inter-affiliate swaps, calling it a “considerable retreat” from the CFTC’s September 2014 proposal and the joint rule adopted by the banking regulators. Initial margin acts as a “shock absorber,” she noted, and CFTC staff has reported that inter-affiliate swaps may account for up to 50 percent of all swaps. With large financial institutions having hundreds or thousands of affiliates around the globe, operating in different financial and legal systems, not requiring initial margin removes a key safety feature, she said.

Chairman Massad disagreed with this assessment, saying that inter-affiliate swaps are not outward-facing and do not increase overall risk. He observed that there is still an anti-evasion requirement and said the exemption was consistent with a 2013 rule exempting inter-affiliate swaps from the general clearing requirement.

Implementation schedule. Initial margin requirements will be phased in between September 1, 2016 and September 1, 2020. Variation margin requirements will be effective September 1, 2016 for the largest market participants and March 1, 2017 for the others.

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