Katten

FINANCIAL MARKETS AND FUNDS ADVISORY

Initial Margin Guidance for US Swap End Users

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I. Introduction

Thanks to recent actions taken by the Commodity Futures Trading Commission (CFTC) and the five US prudential regulators responsible for the uncleared swap margin rules for bank swap dealers,[1] most US end user participants in the derivatives markets (i.e., anyone other than a swap dealer) will now not be at risk for having to post mandatory regulatory initial margin (IM) for their uncleared swap transactions until September 1, 2022. These recent actions have aligned the US schedule for the phase-in of mandatory regulatory IM for uncleared swaps with the revised global schedule recommended by the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO). As a result, the compliance date for any entity with an average aggregate notional covered transaction portfolio of more than $50 billion must comply regulatory IM rules will be September 1, 2021, and the compliance date for any other entity will be September 1, 2022.[2] Under the regulatory IM rules, each party to an in-scope uncleared derivative must post the same specific amount of IM (calculated using standard regulatory percentages or an approved margin model) to an account with an independent custodian.

Despite this postponement, end users should continue planning for an IM future and, to facilitate that planning, Katten is offering this Initial Margin Guidance, which summarizes all the initial margin rules for uncleared swaps from the perspective of a US end user of swaps.[3]

II. Executive Summary

Regulatory IM does not apply automatically to end user derivative transactions. Under US swap laws and rules, a derivative transaction being executed or amended by an end user is only subject to mandatory regulatory IM if all of the following statements about the end user, its counterparty, and the relevant derivative transaction are true:

1. The counterparty is registered with the CFTC as a swap dealer.
2. The end user is a Financial End User (as defined in the PR or the CFTC IM Rules).
3. The end user is not an affiliate of its swap dealer counterparty.
4. Both the end user and the swap dealer have passed their respective IM compliance dates.
5. The end user has Material Swaps Exposure (as defined in the PR and CFTC IM Rules) for the year in which the derivative is being executed or amended.

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[1] The prudential regulators are the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (the Fed), the Federal Deposit Insurance Corporation (FDIC), the Farm Credit Administration and the Federal Housing Finance Agency. A swap dealer that has a "prudential regulator" (i.e., a bank or "PR Swap Dealer") is subject to the prudential regulator margin rules for uncleared swaps (the "PR IM Rules"). Other swap dealers ("CFTC Swap Dealers"), including ones that are subsidiaries or affiliates of banks, are subject to the CFTC margin rules (the "CFTC IM Rules").

[2] See Exhibit A summarizing the recent IM actions by US regulators.

[3] This Guidance does not deal with the IM rules for security-based swaps and security-based swap dealers.

6. The derivative is a swap or mixed swap; or the derivative is a security-based swap and the counterparty is a PR Swap Dealer.
7. The aggregate IM exposure between the parties (including the derivative to be executed or amended and calculated either using the regulatory IM table or the ISDA Standard Initial Margin Model (SIMM)) exceeds $50 million.
8. The derivative is not a Legacy Swap (as defined below).
9. If even one of the statements above is NOT true, then regulatory IM does not apply. (As always, however, a swap dealer can insist on initial margin as a negotiated commercial term of your derivative transactions, but the terms of such initial margin do not have to comply with government regulations.)

III. Analysis

The following sections provide more detail on how a US end user can determine if and when mandatory regulatory initial margin (IM) applies to one of its derivative transactions:

1. Is your counterparty a swap dealer?

No regulatory IM applies to a derivative unless your counterparty is a swap dealer registered with the CFTC. A list of all swap dealers can be found on the website of the National Futures Association (NFA).

Since the PR IM Rules differ from the CFTC IM Rules in at least their treatment of security-based swaps, it may be important to know if a particular swap dealer is a PR Swap Dealer. While is it generally safe to assume that any swap dealer that is a bank does have a prudential regulator, there is no official list of PR Swap Dealers. The NFA recently estimated that there are 52 PR Swap Dealers and 55 CFTC Swap Dealers.[4]

2. Are you a Financial End User?

No regulatory IM applies to a derivative executed with a swap dealer unless (a) the end user is a Financial End User; and (b) the end user is not entitled to an exemption from mandatory swap clearing. The definition of Financial End User is attached as Exhibit B.[5]

The definition of Financial End User differs from the definition of "Financial Entity," which is the type of entity that is subject to mandatory clearing. Therefore, although it is likely that any Financial Entity will also be a Financial End User, that is not always the case. In particular, definitional outcomes are not always the same because the sub-categories of Financial End User are quite specific and the catchall provisions in the two definitions are very different. The catchall provision in the Financial End User definition presents some interpretive challenges due to its "run on sentence" nature.

3. Is your counterparty an affiliate?

Affiliates are not subject to regulatory IM under the CFTC IM Rules. That was not originally the case for the PR IM Rules, but they have recently been amended to match that result, albeit with a significant practical twist. The twist is that the exclusion ceases to apply if the aggregate of all initial margin that would have to be posted in the absence of the exclusion exceeds 15 percent of the PR Swap Dealer's tier 1 capital. A PR Swap Dealer consequently still has to calculate initial margin for any affiliate swaps relationship on a daily basis and track the aggregate result against the tier 1 capital limit.

[4] See footnote 1, NFA Comment Letter on Capital Requirements of Swap dealers and Major Swap Participants, March 2, 2020.

[5] There is a very slight difference between the definition of Financial End User for swap dealers that have a prudential regulator and those that do not.

4. Have both parties passed their respective IM compliance dates?

No regulatory IM applies to a derivative executed with a swap dealer unless both the end user and the swap dealer have passed their respective IM compliance dates. There were originally five compliance dates for IM, but now there are six. Four compliance dates have already occurred, so the IM rules already apply to many swap dealers based on this criteria. However, there is no list identifying such swap dealers.

The next compliance date (No. 5) will be September 1, 2021 and will apply to any entity (end user or dealer) that has not yet had a compliance date if the daily (business day only) average aggregate notional amount (DAANA) of all the uncleared swaps, security-based swaps, FX swaps and FX forwards executed by the entity and all its margin affiliates for March, April and May of 2021 exceeds $50 billion. An end user cannot calculate its DAANA without information about the enumerated transactions executed by every one of its margin affiliates. An entity is a margin affiliate of another entity if either entity consolidates the other on a financial statement, or both entities are consolidated with a third entity on a financial statement.[6]

Any entity that has not had an earlier compliance date will have September 1, 2022 as its compliance date (No. 6).

Every swap end user must have a process for calculating DAANA for determining if compliance date No. 5 applies. Since your DAANA calculation will not be publicly available information, any swap dealer you do business with will need representations about your compliance date.

5. Do you have Material Swaps Exposure?

Even if the IM compliance dates for both parties have passed, no regulatory IM applies unless the end user has Material Swaps Exposure for the calendar year in which a derivative is being executed, a term that is significantly euphemistic because it is not really a measure of either materiality (since the threshold does not change based on the size of the end user), swaps (since it looks at other products as well) or exposure (since it is concerned only with notional amounts). An end user will have Material Swaps Exposure for any calendar year if its DAANA for June, July and August of the *immediately preceding* calendar year exceeds $8 billion.[7] (For example, if the end user's compliance date will be September 1, 2022, the end user will not actually be in scope on that date unless its DAANA for June, July and August of 2021 exceeds $8 billion.) Starting with 2023, if an end user has Material Swaps Exposure for a particular year (based on its DAANA for June, July and August of the immediately preceding year), the end user's IM obligation starts on January 1, not September 1, of that year.

The DAANA calculation for Material Swaps Exposure is done in the same way as the calculation for your compliance date, but is applied to a different three-month period. Since your Material Swaps Exposure calculation will not be publicly available information, any swap dealer you do business with will need representations about your MSE status.

6. Is your specific derivative transaction subject to IM?

Even if the IM compliance dates for both parties have passed and the end user has Material Swaps Exposure for the year in which a derivative is being executed, no regulatory IM applies unless (a) the parties are executing a type of derivative that is covered by the rules applicable to the swap dealer counterparty; and (b) the derivative is not cleared with a clearinghouse registered with the CFTC as a "Derivatives Clearing Organization."[8]

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[6] A typical fund is unlikely to have any margin affiliates.

[7] The CFTC announced in an open meeting on May 22 that it will be proposing a rule to change the timing of the calculation of Material Swaps Exposure but has not yet released written details of that proposal.

[8] These product distinctions apply to variation margin (VM) as well as initial margin, but have not received much attention because the standard market practice for determining VM is to calculate net exposure for all derivative transactions (swaps, documented under the same master netting agreement without regard to whether the transactions are technically in-scope.

For purposes of applying the IM rules, derivatives can be categorized in accordance with the following rubrics:

A. A derivative that meets the CEA definition of a "swap" is always subject to regulatory IM.

B. A swap on a single security, single loan, or a narrow-based basket or index of securities is generally a security-based swap (SBS) that is currently subject to regulatory IM only if the end user's counterparty is a PR Swap Dealer. Security-based swaps are not currently subject to regulatory IM if the counterparty is a CFTC Swap Dealer and is therefore subject to CFTC IM Rules.

C. An SBS that includes economic features found in a swap is a "mixed swap" that is subject to regulatory IM when executed with any swap dealer. A common example of a mixed swap is a "compo" equity derivative that is denominated in a currency different from the settlement currency of the underlying securities, and uses different exchange rates for conversion at the start and the end of the transaction.

D. A derivative that is neither a swap nor an SBS is a non-swap derivative (NSD) that is not subject to regulatory IM. Typical NSDs are deliverable FX forwards and equity options.

Because of the cost associated with IM, parties will want to discuss if they are willing and able to take these product distinctions into consideration for their IM calculations.

7. Have you reached the $50 million IM threshold with the swap dealer?

A swap dealer is not required to exchange IM with an in-scope counterparty until the IM exposure between the parties (calculated either using the regulatory IM table or the ISDA SIMM) exceeds the initial margin threshold, which is defined to be an aggregate credit exposure of $50 million resulting from all uncleared swaps between the dealer and its margin affiliates on the one hand, and the counterparty and its margin affiliates on the other.[9] The CFTC and the prudential regulators have both clarified that the contractual and custodial documentation needed to support the exchange of IM at an independent custodian consequently does not have to be completed until the $50 million threshold is reached and IM is actually due.[10] In this context, the CFTC has stated that "to the extent the $50 million IM threshold is not exceeded, there are no applicable IM requirements, and no need for any pertinent documentation or custodial arrangements."[11] Therefore, if an end user keeps its IM exposure with a swap dealer below the threshold, IM does not apply. However, if exposure goes over the threshold before compliant documentation is in place, the swap dealer (but not the end user) will be in violation of its regulatory IM obligations, so no swap dealer will want to wait until the last minute to finish IM documents with an otherwise in-scope end user.

8. Is your derivative a Legacy Swap?

IM does not apply to any transaction (each, a "Legacy Swap") executed before the compliance date for both parties has been reached that would have been subject to regulatory IM if executed after that date. The regulators, however, take the general position that any material change to a Legacy Swap (such as an assignment or amendment) that is made after the IM rules are applicable to a swap dealer and its counterparty will cause the Legacy Swap to become subject to regulatory IM.[12] The regulators have nevertheless conceded that some types of post-compliance date changes should not cause a Legacy Swap to become subject to mandatory IM. These permitted changes include:

A. immaterial amendments,
B. partial terminations and novations,
C. swaption exercises, and
D. amendments to deal with unexpected market-wide developments such as Brexit, the Qualified Financial Contract Rules, and LIBOR replacement.[13]

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[9] If a swap dealer does swap business with more than one entity in a corporate group, the dealer will have to allocate the initial margin threshold among those entities as a contractual matter.

[10] CFTC Letter 19-16, July 9, 2019. The prudential regulators adopted a similar interpretation on June 25, 2020.

[11] CFTC Letter 19-16, July 9, 2019, p.5.

[12] See CFTC Letter 19-13, June 6, 2019, at p. 3. This position reflects a concern that market participants could game the IM rules by endlessly amending Legacy Swaps and never entering into "new" swaps.

[13] See CFTC Rule 23.161(d) and CFTC Letter 19-13, June 6, 2019.

Changes to the terms of a trade caused by the x) the provisions of the relevant contract (as in the case of an amortizing notional amount); y) events outside the control of the parties (such as a stock split); and z) changes to a portfolio swap that are permitted without the consent of the other party, are not considered to be amendments that change the IM status of the trade.

IV. A Cautionary Note About Non-US Swap Dealers

The IM status of a US end user and its derivative transactions with a swap dealer may be affected by additional points than the ones described above if the swap dealer is also subject to margin rules in another jurisdiction. In general, the implementation of margin rules for uncleared swaps have been well-coordinated globally, but there are some differences. A swap dealer subject to margin rules in two jurisdictions must apply the stricter of the two rules. A simple example of such a difference is the fact that equity options are subject to initial margin under European Union initial margin rules for uncleared swaps, but not under US rules.

V. IM Action Steps

A US financial end user that expects to have Material Swaps Exposure for the year in which it passes its compliance date (or in any subsequent year) should take the following actions:

A. Confirm that it is correctly calculating its DAANA across all margin affiliates.

B. Become familiar with the way the ISDA SIMM works.

C. Establish a custodial relationship with an independent custodian to hold IM.

D. Confirm which set of margin rules applies to each swap dealer counterparty it has.

E. Identify the IM status of each type of derivatives it uses.

F. Establish its preferred terms for IM and account control documentation.

G. Negotiate IM and account control documentation with each of its swap dealer counterparties.

CONTACTS

For more information, please contact any of the following members of Katten's Financial Markets and Funds practice.

Guy Dempsey
+1.212.940.8593
guy.dempsey@katten.com

Carolyn H. Jackson
+44 (0) 20 7776 7625
carolyn.jackson@katten.co.uk

Carl E. Kennedy
+1.212.940.8544
carl.kennedy@katten.com

Don J. Macbean
+1.212.940.8983
don.macbean@katten.com

Krassimira Zourkova
+1.310.788.4534
krassimira.zourkova@katten.com

EXHIBIT A

Postponement of Phases 5 and 6 for Initial Margin

BCBS/IOSCO	**Published recommendation to postpone Phases 5 and 6 on April 3, 2020.** https://www.bis.org/press/p200403a.htm
CFTC	**Phase 5 postponement adopted June 25, 2020 by a final rule that became effective on July 10, 2020.** https://www.govinfo.gov/content/pkg/FR-2020-07-10/pdf/2020-12033.pdf **Phase 6 postponement was proposed for comment June 25, 2020. Comments on the proposal are due by September 8, 2020.** https://www.cftc.gov/sites/default/files/2020/07/2020-14254a.pdf?utm_source=govdelivery
Prudential Regulators	**Phase 5 and 6 postponement adopted by Interim Final Rule on June 25, 2020. Interim Final Rule is effective September 1, 2020.** https://www.govinfo.gov/content/pkg/FR-2020-07-01/pdf/2020-14094.pdf

EXHIBIT B

"Financial End User" means any party to a derivative that is not a swap dealer, security-based swap dealer, major swap participant or major security-based swap participant but is:

(i) A bank holding company or an affiliate thereof; a savings and loan holding company; a US 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);

(ii) 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));

(iii) An entity that is state-licensed or registered as

(A) 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;

(B) a money services business, including a check casher; money transmitter; currency dealer or exchange; or money order or traveler's check issuer;

(iv) 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;

(v) 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 ;

(vi) 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));

(vii) 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

(viii) 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));

(ix) 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);

(x) 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;

(xi) 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:

(A) [text from CFTC Margin Rules] investing or trading or facilitating the investing or trading in loans, securities, swaps, funds, or other assets; or

(B) [text from Prudential Regulator Margin Rules] 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

(xii) 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 of an entity that is not a financial entity 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.