



Corporate and Association Counsel Division

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Key Insights into Dodd-Frank Margin Requirements for Uncleared Swaps for Counsel and Compliance Officers

The Dodd-Frank Wall Street Reform and Consumer

Protection Act (Dodd-Frank) brought significant changes to the securities market, including dealers, funds, banks, and companies.¹ In turn, this led to increased internal compliance measures and, perhaps, to in-house counsel needing to learn about complex trades associated with derivative trades for uncleared swaps and margin requirements. Two sections of Dodd-Frank address these types of trades. Sections 731 and 764 address the “Registration and Regulation of Major Swap Dealers and Participants.”² These two sections, along with other areas of Dodd-Frank, amended the Commodity Exchange Act by adding section 4s.³ Subsequently, the U.S. Securities and Exchange Commission (SEC) issued a proposed rule, which was published in the September 24, 2014, *Federal Register*.⁴ The Federal Reserve, along with the board of governors of the Federal Reserve System, the Farm Credit Administration, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, and the Office of the Comptroller of the Currency (collectively, the Prudential Regulators), issued a statement before the proposed rule was published in the *Federal Register*.⁵ Specifically, the proposed rule would establish minimum requirements for the exchange of initial and variation margin between covered swap entities and their counterparties to noncleared swaps and noncleared security-based swaps. The margin requirements mandated by Dodd-Frank are intended to address a number of weaknesses in the regulation and structure of the swap markets that were revealed during the recent financial downturn. The requirements are intended to reduce risk, increase transparency, and promote market integrity.

This proposal builds on one originally released by the regulators in April 2011 and includes some modifications that were made in

light of comments, such as an expansion of the types of collateral eligible to be posted as initial margin. This proposal also seeks to promote global consistency by generally following the final framework for margin requirements on noncleared derivatives that the Basel Committee on Banking Supervision and the International Organization of Securities Commissions adopted in September 2013.⁶

In light of the complexities associated with swaps and margins, we want to provide lawyers, compliance officers, executives, and directors with an understanding of the rule and the industry impact, as well as the cost of compliance and implementation. While these types of transactions are generally found in the banking and energy sectors, there could be an impact on a company’s financials, regardless of the industry.

Understanding the Basics of Swaps and Margins

What is the difference between a noncleared swap and a noncleared security-based swap? In general, a noncleared swap is “a swap that is not subject to mandatory clearing or a swap with respect to which a party to the swap is eligible for, and takes advantage of, an exemption from the mandatory clearing requirement.”⁷ According to the International Swaps and Derivatives Association (ISDA), “[t]he non-cleared segment of the OTC derivatives market includes many important products with significant value to the economy. These products enable industrial companies and governments to effectively finance and manage risk in their operations and activities, and help pension funds meet their obligations to their retirees. They help support economic growth by enabling banks to lend to corporate and individual customers. They play a vital role in virtually every industry—from financial services to international

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trade to home mortgages. As the Financial Stability Board has noted: ‘Demand for bespoke products comes from a variety of market participants. These include nonfinancial corporate end users such as airlines, financial sector end users such as insurance companies and banks, as well as hedge funds and institutional investors including pension funds, mutual funds, university endowments and sovereign wealth funds. Derivatives dealers themselves also may have tailored needs that can be met through the use of bespoke products.’⁸

By way of contrast, a security swap is a swap that is based on an index that is a narrow-based security, including any interest therein or value thereof; a single security loan, including any interest therein or value thereof; or “the occurrence, nonoccurrence or extent of the occurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index, provided that such event directly affects the financial statements, financial conditions, or financial obligations of the issuer.”¹⁰

While there are differences between security-based swaps and non-security based swaps, the law applies equally to both. Some other definitions that counsel need to familiarize themselves with are:¹¹

- **Covered counterparty.** A financial end user with material swaps exposure, a swap dealer, or a major swap participant who enters into a swap with a covered swap entity.
- **Covered swap entity.** A swap dealer or major swap participant for whom there is no prudential regulator.
- **Nonfinancial end user.** A counterparty that is not a swap dealer, a major swap participant, or a financial end user.
- **Uncleared swap.** A swap that is not cleared by a registered derivatives clearing organization (DCO) or by a clearing organization that has received a no-action letter or other exemptive relief from the Commodity Futures Trading Commission (CFTC) permitting it to clear certain swaps for U.S. persons without being registered as a DCO.

But, how do these definitions work in the context of the proposed rule and process improvement? The next sections provide the answers.

Rule Background

The CFTC-proposed rule for Dodd-Frank, “Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 17 CFR Parts 23 and 140,” was published on Oct. 3, 2014, and identifies several new key requirements for how swap dealers (SDs) and major swap participants (MSPs), also referred to as Covered Swap Entities (CSEs), must adopt initial and variation margin requirements. “[A] CSE must collect [initial margin (IM)] from a counterparty that is a (i) swap entity, or (ii) a financial end user with material swaps exposure (\$3 billion notional during June, July, and August of the previous year) in an amount that is no less than the greater of: (i) zero (0) or (ii) the IM collection amount (\$65 million—not including any portion of the IM threshold amount already applied by the covered swap entity or its affiliates to other swaps with the counterparty or its affiliates).”¹²

It is important to note that a CSE is not required to collect IM from or post IM to commercial end users. Tim Massad, the new CFTC chairman, has stated that the rule-making is designed to “minimize the burden” on commercial hedgers and make sure



that the CFTC’s regulatory scheme “recognizes the needs and concerns of commercial end users who depend on the derivatives markets to hedge normal business risks.”¹³ CSEs are also required to either pay or collect variation margin from its counterparties (that are swap entities or financial end users) on or before the business day after execution of an uncleared swap, as a result of the change in value of obligations since the trade was executed or the previous time payment for the initial obligation was made.

The CSE is not required to collect, post, or pay variation margin unless the total amount of margin transfer exceeds the minimum transfer amount of \$650,000. The rule also specifies associated requirements for model requirements for margin calculations with stress calibration and frequency of calculation guidance, close-out period specifications, control mechanisms, counterparty documentation guidance, and record retention guidance. It is proposed that CSEs must comply with the variation margin requirements by Dec. 1, 2015, and the initial margin requirements by Dec. 1, 2019, with a “phased-in” period beginning on Dec. 1, 2015 based on daily aggregate notional amounts.

Industry/Process Impact

Like the majority of other Dodd-Frank regulations, this rule will impact a variety of industries and companies that trade in uncleared swaps, in addition to the financial services industry. Energy companies and airlines will be impacted, as they commonly transact in

the swap markets for hedging purposes. Product categories permitted to take advantage of portfolio offsets in the margin calculation models, if governed under the same Eligible Master Netting Agreement (EMNA), include agriculture, credit, energy, equity, foreign exchange, interest rate, metals, and other categories. The company must, however, take the sum of the initial margin calculations for each asset class category after netting within each asset class (if supported correlations exist) to arrive at the total initial margin calculation.

While swap dealers have continued to face implementation challenges in developing new processes to comply with Dodd-Frank, these proposed margin and clearing rules may increase the administrative burden significantly for several reasons. First, more activities will be required to be performed by the risk management unit, which reports directly to senior management, which was initially established by the Internal Business Conduct Standards rule 23.600(c) (4)(i). After creating the model, to calculate the margin values they must validate the model prior to implementation and on an on-going basis. The rule also requires that the model be benchmarked periodically against observable margin standards to determine that any initial margin calculation is subject to a readily observable minimum. It appears more clarification will be needed to further define what this “readily observable minimum” will be.

The CSE also should consider having an internal audit function independent of the business trading unit annually assess the effectiveness of the controls supporting the model, similar to what we have seen in other parts of the Internal Business Conduct Standards rules for validation of the Risk Management Program.

Process development will be required for the ongoing model monitoring process, as well as control testing development. Companies may also consider the development of processes in the event that a margin calculation dispute arises with their counterparties, possibly requiring legal consultation. A proactive approach is to have contingencies identified beforehand and addressed in the contract. Additionally, depending on where the counterparty is located, international laws may need to be taken into consideration. Failing to adhere to the law may implicate significant civil monetary penalties and criminal liability. Many swap dealers have worked to build automated calculation engines, models, and technology applications to support gross notional value calculations, large trader reporting, daily mark-to-market reporting, trade option reporting, and other Dodd-Frank processes. This will most likely be another area companies seek to utilize technology to create a more automated and consistent process, less prone to manual entry errors.

For those CSEs who may find this model development and testing process to be overwhelming, there is another, table-based method presented as an alternative option, which would allow the CSE to calculate its initial margin requirements using a standardized table.

Cost/Other Implications

With either model development option the CSE takes to comply with these new rules, it is likely a CSE will need to consider increasing their resources to handle the additional workload, potentially reinstate Dodd-Frank implementation teams to address process changes, work with their in-house or external legal counsel to clarify questionable rule areas needed for implementation decisions, develop needed technology, and coordinate with internal audit teams to adjust future audit testing plans. They will likely face increased

costs from these activities, in addition to the cost of capital from having to post increased margin on portfolios in which they are short uncleared swaps. They could also face increased costs from interest required to raise additional capital for margin. If the costs of this increased margin become close to the costs of clearing, we will most likely see a loss of market participants and even less uncleared swap activity in the marketplace. We may also see a shift in SDs and MSPs transacting more with commercial end users and less with swap entities and financial end users.

Conclusion

The overall goal of the regulations is to increase transparency, while enabling innovation and decreasing risk. Needless to say, this is a complex area of law that requires consulting people with particular areas of expertise. In-house counsel should work closely with external counsel and consulting companies to make sure many areas of compliance are being met. Doing so can result in a win-win for all parties involved—including counterparties.

Endnotes

¹The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203 (Jul. 21, 2010) (indicating that the legislative intent behind the law was “to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end ‘too big to fail,’ to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes”).

²*Id.*

³The Commodity Exchange Act (7 U.S.C. 1 et seq.). *See also*, 7 U.S.C. 6s.

⁴79 Fed. Reg. 57348, 57357 (Sept. 24, 2014).

⁵Board of Governors of the Federal Reserve System, *Agencies Seek Comment on Swap Margin Requirements* (Sept. 3, 2014), available at www.federalreserve.gov/newsevents/press/bcreg/20140903c.htm.

⁶*Ibid.*

⁷*Prudential Regulators Propose Margin Requirements for Non-Cleared Swaps* (Oct. 21, 2014), available at www.willkie.com/~media/Files/Publications/2014/10/Prudential_Regulators_Propose_Margin_Requirements_For_Non_Cleared_Swaps.pdf.

⁸International Swaps and Derivatives Association, *Non-Cleared OTC Derivatives: Their Importance to the Global Economy* (Mar. 2013) (internal citations omitted), available at www.isda.org.

⁹*See* www.sec.gov/spotlight/dodd-frank/derivatives.shtml (last accessed Nov. 29, 2014).

¹⁰77 Fed. Reg. 48207 (Aug. 13, 2012) (citing the joint final rule by the Commodity Futures Trading Commission and Securities and Exchange Commission, *Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap*).

¹¹*Supra*, n. 4.

¹²*See* www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister092314a.pdf (last accessed Jan. 22, 2015).

¹³FIA Special Report: CFTC Proposes Special Margin Rule, Finalizes Rule on Swaps with Utilities (published Sept. 17, 2014).