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Legal Alert: The Deadline for Compliance With the U.S. Variation Margin Rules Is Approaching! Are You Ready?

December 20, 2016

The requirement that non-cleared swaps be fully margined, which is one of the last pillars of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), will take effect for "financial end-users" on March 1, 2017. Compliance with the new requirements will necessitate changes to existing trade documentation and collateral management practices. Financial end-users should be working to make the necessary changes now in order to ensure uninterrupted trading of non-cleared swaps with swap dealer counterparties after the March 1 compliance date.

Margin Rules

Last year, U.S. federal regulators adopted final regulations[i] to require persons, registered as "swap dealers," to post and collect margin to and from their non-cleared swaps counterparties that are: (1) also swap dealers; or (2) "financial end-users."[ii] Specifically, with respect to financial end-users, swap dealers will be required to exchange variation margin daily and, to the extent that a financial end-user has "material swaps exposure," initial margin as well. It is important to note that financial end-users are not directly subject to the margin rules. Only swap dealers are directly subject to the margin rules; thus, financial end-users will not be exposed to regulatory liability for noncompliance with such rules. However, financial end-users will be required by swap dealers to comply with the margin rules as a condition to trading with them.

- *Variation Margin Requirements*

When facing a swap dealer counterparty with respect to a non-cleared swap, financial end-users will be required to post or collect variation margin, representing the mark-to-market value of the swap, on a daily basis. The requirement to exchange variation margin cannot be subject to a threshold amount (,*i.e.*, zero thresholds are required) and a $500,000 minimum transfer amount (or lower) applies. The margin rules specifically identify the assets that are considered eligible collateral for variation margin, which includes, among other things, cash, Treasuries, agency securities, and corporates, each subject to specified haircuts and limitations.

The variation margin requirements are subject to the following phased-implementation timeline:

Compliance Date	Variation Margin Requirements
September 1, 2016	Variation margin where both the covered swap entity combined with all its affiliates and its counterparty combined with all its affiliates have an average daily aggregate notional amount of covered swaps for March, April and May of 2016 that exceeds $3 trillion.[iii]
March 1, 2017	Variation margin for any other covered swap entity with respect to covered swaps with any other counterparty.

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Since the last compliance date has no minimum notional amount requirement, all financial end-users must be in compliance with the variation margin requirements by March 1, 2017.

Side Bar: Calculating "Average Daily Aggregate Notional Amount"
The margin rules require the calculation of one's average daily aggregate notional amount in several instances. Per the margin rules, average daily aggregate notional amount is to be calculated only for business days. Instruments that are outside the scope of the margin rules (i.e., those instruments that are not swaps) are to be excluded from the calculation, with the exception of foreign exchange forwards and foreign exchange swaps, which must be included in the calculation (even though they are not subject to the margin requirements). The following example is taken from the preamble to the margin rules[iv] A financial end-user (together with its affiliates) would have an average aggregate notional amount of non-cleared derivatives for the months of March, April and May 2016 of $3.3 trillion if the following were true: • The financial end-user has a portfolio consisting of two non-cleared swaps (e.g., an equity swap and an interest rate swap) and one non-cleared security-based swap. • The notional value of each swap is exactly $1 trillion on each business day of March, April and May of 2016. • A foreign exchange forward is added to the entity's portfolio at the end of the day on April 29, 2016, the notional value of which is $1 trillion on every business day of May 2016. Based on this, the financial end-user's aggregate notional amount of non-cleared swaps and security-based swaps for March 2016 and April 2016 would be $3 trillion. The financial end-user's aggregate notional amount of non-cleared swaps and security-based swaps for May 2016 would be $4 trillion. When March, April and May 2016 are averaged, the end-user's average aggregate notional amount would be $3.3 trillion.

- *Initial Margin Requirements*

In addition to posting or collecting variation margin, the margin rules will require swap dealers to exchange initial margin with financial end-users that have "material swaps exposure." A financial end-user is deemed to have material swaps exposure if the average daily aggregate notional amount of its non-cleared swaps and non-cleared security-based swaps for each business day in June, July, and August of the preceding year exceeds $8 billion.

The initial margin requirements for financial end-users align with the variation margin requirements in terms of transfer timing (,*i.e.*, initial margin must be exchanged daily), eligible collateral, and the $500,000 minimum transfer amount. However, the rules do permit threshold amounts on a per counterparty basis of up to $50 million. In addition, each party's initial margin must be segregated with a custodian and cannot be rehypothecated.

The initial margin amount is to be calculated by the swap dealer pursuant to a table included with the margin rules or via another model that has been approved by the regulator that oversees the swap dealer. The swap dealer community, through ISDA, has developed a uniform model for this purpose known as the "Standard Initial Margin Model" or "SIMM."[v] It is anticipated that the SIMM will be a model widely used by swap dealers to avoid dealers having their initial margin requirements subject to different models depending on the counterparty. The SIMM is less conservative than the default model for calculating initial margin contained in the margin rules.

The initial margin requirements are subject to the following phased-implementation timeline:

Compliance Date	Initial Margin Requirements
September 1, 2016	Initial margin where both the covered swap entity combined with all its affiliates and its counterparty combined with all its affiliates have an average daily aggregate notional amount of covered swaps for March, April and May of 2016 that exceeds $3 trillion.
September 1, 2017	Initial margin where both the covered swap entity combined with all its affiliates and its counterparty combined with all its affiliates have an average daily aggregate notional amount of covered swaps for March, April and May of 2017 that exceeds $2.25 trillion.
September 1, 2018	Initial margin where both the covered swap entity combined with all its affiliates and its counterparty combined with all its affiliates have an average daily aggregate notional amount of covered swaps for March, April and May of 2018 that exceeds $1.5 trillion.
September 1, 2019	Initial margin where both the covered swap entity combined with all its affiliates and its counterparty combined with all its affiliates have an average daily aggregate notional amount of covered swaps for March, April and May of 2019 that that exceeds $0.75 trillion.
September 1, 2020	Initial margin for any other covered swap entity with respect to covered swaps with any other counterparty.

Given the high level of notional amount that triggers earlier compliance, we assume that the vast majority of financial end-users will need to be in compliance with the initial margin requirements by September 2019 at the earliest.

- *Retroactive Effect of the Margin Rules*

Technically, the variation and initial margin requirements apply only to swaps executed on or after the applicable compliance date. However, the margin rules stipulate that if counterparties wish to net post-compliance date non-cleared swaps with non-cleared swaps that were executed before the applicable compliance date (referred to as legacy trades) for the purpose of calculating the amount of required margin, then it is necessary to apply the requirements to all of the non-cleared swaps.

According to the margin rules, it is possible to avoid this by establishing distinct netting sets within one's trading agreement. For example, a financial end-user that has an existing ISDA Master Agreement and Credit Support Annex (CSA) in place with its swap dealer counterparty for an existing book of transactions could enter into a new, second CSA with such counterparty, under the same ISDA Master Agreement that complies with the new margin rules, to apply only to non-cleared swaps that are executed on or after the applicable compliance date. This would preserve close-out netting for all transactions under the ISDA Master Agreement but ensure that margin amounts for particular sets of transactions are netted and calculated separately. This approach may make sense if a financial end-user has preferable terms in its existing CSA (,*e.g.*, thresholds) that would be lost by virtue of the new margin requirements. Approaches for bringing documentation into compliance with the margin rules are further discussed below.

Cross-Border Issues

While this article focuses on the margin requirements of the United States under Dodd-Frank, if a U.S. end-user trades with non-U.S. persons, the margin requirements of other jurisdictions may also apply. Fortunately, the U.S. margin rules largely align with the recommendations of the Basel Committee on Banking Supervision (BCBS) and the Board of the International Organization of Securities Commissions (IOSCO), which were published in 2012 (and subsequently updated in 2015) and are intended to create an international framework for margin requirements on non-cleared derivatives.[vi] Many non-U.S. jurisdictions, including Japan, the European Union, Switzerland, Canada and Australia, have also generally followed the BCBS-IOSCO recommendations, including with respect to the timing of implementation. However, there are some notable differences that market participants should be aware of, including with respect to eligible collateral, haircuts, the scope of covered transactions, and transfer timing.

To the extent that there are differences between the U.S. margin rules and the margin rules of another jurisdiction, compliance with both jurisdictions' requirements will be necessary unless an equivalence determination is issued by the relevant regulators permitting compliance with one jurisdiction's requirement over the other's. As of the date of this article, no such equivalence determination has been issued in the United States with respect to the requirements of other jurisdictions, nor are we aware of equivalence determinations issued by other jurisdictions. The practical effect of this is that where two jurisdictions' margin rules apply, it will be necessary to comply with the more restrictive set of requirements.[vii]

Necessary Changes to Documentation

As noted above, financial end-users who desire to continue trading with their swap dealer counterparties will be required to comply with the applicable margin rules. In order to comply with the requirements imposed by the margin rules, it will be necessary for financial end-users to amend their existing trading documentation. Notably, the margin rules may require amendment of the following terms (among others), to the extent that they do not already comply with the new requirements:

- Eligible collateral and haircuts
- Threshold amounts
- Treatment of initial margin and variation margin (,*e.g.*, segregation, rehypothecation, etc.)
- Transfer timing
- Minimum transfer amounts

Generally, financial end-users have two options for effecting the necessary amendments. They may: (1) utilize a new ISDA Variation Margin Protocol; or (2) enter into bespoke amendment agreements with each of their swap dealer counterparties. There is also an option to use an ISDA 2016 Credit Support Annex for Variation Margin (the 2016 VM Bookstore CSA), that was published last spring, on a bilateral basis.[viii]

- *The ISDA Variation Margin Protocol*

In August 2016, ISDA published a Variation Margin Protocol (the VM Protocol) that is intended to facilitate compliance with the margin rules of various jurisdictions. Through the VM Protocol, counterparties can amend existing documentation, or enter into new documentation, that complies with the new variation margin requirements. Initially, the VM Protocol addressed the variation margin requirements of the United States, Canada, and Japan. A supplement was subsequently published in November and December 2016 to address the variation margin requirements of the European Union and Switzerland (since the effectiveness of those rules had been delayed). As other countries implement their margin rules, other VM Protocol Supplements and Questionnaires will be published.

The VM Protocol consists of a Protocol Agreement, Questionnaire, and Supplement.[ix] The Supplement is the substantive portion of the VM Protocol that actually amends one's existing documentation or creates new documentation. However, in order for the terms of the Supplement to apply, one must first agree to the Protocol Agreement (which essentially is an agreement to amend one's existing trading documentation via the VM Protocol) and, subsequently, exchange Questionnaires with each trading counterparty. The Questionnaire identifies the manner in which the VM Protocol's provisions will be applied and has limited options that can be chosen or defaulted to by the parties. Subsequent Supplements can be agreed to through additional Questionnaires exchanged by the parties.

Financial end-users utilizing the VM Protocol will have to make numerous elections in the Questionnaire, including which jurisdiction's margin regimes are to be addressed via the VM Protocol (which can be just one regime's rules or a combination of regimes' rules). As a precursor to adhering to the VM Protocol, financial end-users may be asked by their swap dealer counterparties (or otherwise find it useful) to exchange a form letter created by ISDA called a "Regulatory Margin Self-Disclosure Letter" (the Self-Disclosure Letter).[x] The Self-Disclosure Letter was published in June 2016 and is a tool that can be used to determine a counterparty's classification for purposes of the margin rules of various jurisdictions, including the United States, Europe, Canada, Switzerland, and Japan. A financial end-user need fill out only those portions of the Self-Disclosure Letter pertaining to the jurisdictions in which its counterparties are located. Use of the Self-Disclosure Letter is not mandatory and does not purport to create binding contractual representations under one's existing ISDA Master Agreement.

The ISDA VM Protocol can be adhered to via an online platform called ISDA Amend, which has been jointly developed by ISDA and Markit and through which it is possible to electronically exchange: (1) Self-Disclosure Letters; and (2) draft and final VM Protocol Questionnaires.[xi] Alternatively, it is possible to adhere to the VM Protocol and exchange of VM Protocol Questionnaires on a bilateral basis.

Of the key elections to be made in the VM Protocol Questionnaire, the most significant is the method by which the VM Protocol is to apply. The three available methods are as follows:

1. <u>The New CSA Method</u>.

Under this method, counterparties agree to enter into a new CSA that is based on the 2016 VM Bookstore CSA.[xii] Following adherence to the VM Protocol and electing this method, the parties would have a new, second CSA in place that has numerous pre-selected, non-negotiated provisions (,*i.e.*, many of the elections parties would typically make in Paragraph 13 to a CSA are selected already). The new CSA can be used to replace an existing CSA (accomplished via an election in the VM Protocol Questionnaire) or solely for swaps executed after the relevant compliance date for the variation margin requirements. Notably, the new CSA created by this method contains provisions that go beyond those required by the variation margin requirements, namely provisions related to negative interest.

2. <u>The Amend Method</u>.

Under this method, counterparties agree to amend their existing CSA so that it complies with the relevant variation margin rules. Following adherence to the VM Protocol and electing this method, the parties would have a single CSA in place that applies to all swaps between the parties. Stated differently, counterparties that agree to the Amend Method are voluntarily subjecting trades that may have been entered into before the relevant compliance date for the variation margin requirements and, therefore, could be grandfathered, to the new variation margin requirements.

The Amend Method only results in amendments that either: (1) are necessary for compliance with the variation margin requirements; or (2) facilitate compliance with the variation margin requirements.

3. <u>The Replicate and Amend Method</u>.

Under this method, counterparties agree to (1) "replicate" their existing CSA; and (2) amend the replica CSA so that it complies with the variation margin requirements. Following adherence to the VM Protocol and electing this method, the parties would have a new, second CSA in place. The amended replica CSA can be used to replace an existing CSA (accomplished via an election in the VM Protocol Questionnaire) or solely for swaps executed after the relevant compliance date for the variation margin requirements.

The Replicate and Amend Method only results in amendments that either: (1) are necessary for compliance with the variation margin requirements; or (2) facilitate compliance with the variation margin requirements.

- *Bespoke Amendments*

As an alternative to using the VM Protocol, financial end-users can opt to amend their existing CSAs, or enter into new CSAs, on a bilateral basis. This would require the development of tailored documentation for each counterparty to which the variation margin requirements will apply. Use of a bespoke amendment affords counterparties flexibility to address only those aspects of their existing documentation that would not comply with the new variation margin requirements. However, financial end-users should be aware that not all counterparties may be willing to engage in bilateral negotiation of bespoke amendments and instead will require use of the VM Protocol, *e.g.*, due to a concern that the bespoke amendment does not satisfy the margin rules' requirements or that a more detailed review of existing agreements will be required.

The use of bespoke amendments is attractive where: (1) the scope of the changes that need to be made to existing documentation is fairly narrow; and (2) a financial end-user has a relatively small number of derivatives counterparties. In addition, some market participants have expressed a preference for bespoke amendments because (1) full functionality on ISDA Amend has been delayed; (2) the VM Protocol is overly complex;[xiii] and (3) from a document management perspective, the VM Protocol does not provide counterparties with a final, tailored document reflecting the specific changes that have been made to an existing CSA (,*i.e.*, an amended or an amended and restated CSA is not generated after adherence to the VM Protocol).[xiv]

Even if a financial end-user elects to use a bespoke amendment to its CSA to ensure compliance with the variation margin requirements, it is nevertheless worthwhile to look to the substance of the VM Protocol, as ISDA has developed contractual provisions that are intended to facilitate compliance with the variation margin requirements. As examples, the VM Protocol contains: (1) a "legally ineligible credit support" provision that establishes a procedure for the substitution of collateral that was previously eligible collateral for purposes of the variation margin rules but has become ineligible; and (2) where two CSAs result from the VM Protocol (,*i.e.*, the New CSA and Replicate and Amend methods), the VM Protocol contains language that permits certain payment netting between two CSAs that result from use of the VM Protocol.

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Regardless of the manner in which a financial end-user elects to come into compliance with the variation margin requirements, one thing is clear: now is the time to start preparing. The first steps for all market participants are to (1) identify the requirements that will apply; (2) review existing documentation to determine the scope of the changes that need to be made; and (3) decide whether to have the new requirements solely apply on a prospective basis for trading after March 1, 2017. In addition, it would be worthwhile to touch base with existing counterparties with respect to the new requirements and their appetite for different approaches to document compliance. For some financial end-users, the March 1, 2017 deadline may be a non-issue because they have already entered into agreements that satisfy the variation margin requirements. Others who have not done so may find themselves unable to hedge their business risks via non-cleared swaps unless they amend existing trading documentation as needed prior to the compliance date.

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[i] There are two sets of rules imposing margin requirements:

- 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, the Prudential Regulators) jointly issued rules that apply to swap dealers and security-based swap dealers that are subject to the oversight of one of the Prudential Regulators. *See* Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 74,840 (Nov. 30, 2015), ***available at*** https://www.gpo.gov/fdsys/pkg/FR-2015-11-30/pdf/2015-28671.pdf.

- The Commodity Futures Trading Commission (CFTC) issued rules that apply to swap dealers that are not subject to the oversight of one of the Prudential Regulators (*i.e.*, nonbanks), ***available at*** http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2015-32320a.pdf.

Although the Prudential Regulators' rules and the CFTC's rules are not identical, they are substantially the same. Accordingly, and for simplicity, in this article we simply refer to the "margin rules" and only citations to the Prudential Regulators' margin rules have been provided. In addition, we generally refer to "swaps" although the Prudential Regulators' rules will also apply to security-based swaps because security-based swaps are a subset of swaps. The Securities and Exchange Commission (SEC) is expected to issue rules in the future that would apply to security-based swap dealers that are not subject to the oversight of a Prudential Regulator (*i.e.*, nonbanks). Presumably, the SEC's rules will be substantially the same as the Prudential Regulators' and CFTC's margin rules.

[ii] The term "financial end-user" encompasses, among others, insurance companies, investment funds (including private funds, commodity pools, and mutual funds), credit unions, employee benefit plans, and certain government-sponsored enterprises. *See* § __.2 of the Prudential Regulators' margin rules.

[iii] *See* § __.2 of the Prudential Regulators' margin rules.

[iv] *See* footnote 82 of the preamble to the Prudential Regulators' margin rules.

[v] For more information about the SIMM visit the ISDA website, https://www2.isda.org/functional-areas/wgmr-implementation/.

[vi] Margin requirements for non-centrally cleared derivatives, ***available at*** http://www.bis.org/bcbs/publ/d317.pdf.

[vii] So, for example, if a financial end-user's counterparty is a UK entity that is registered as a swap dealer in the United States, compliance with the U.S. and EU margin requirements would be necessary and, to the extent that there are differences between the requirements of the two regimes, the more restrictive requirements should be complied with. We note that there is no problem with this from a regulatory perspective, as the margin rules impose minimum requirements that must be satisfied. More restrictive terms can be agreed to from a commercial perspective or otherwise.

[viii] The 2016 VM Bookstore CSA is *available at* http://www.isda.org/publications/isdacredit-users.aspx. Like the 1994 ISDA form of CSA, the 2016 VM Bookstore CSA is intended to be used on a bilateral basis and can be negotiated.

[ix] The VM Protocol documents are available on the ISDA website, http://www2.isda.org/functional-areas/wgmr-implementation/isda-2016-variation-margin-protocol/.

[x] The form of ISDA Regulatory Margin Self-Disclosure Letter is *available at* http://www.isda.org/publications/pdf/35345836_14_WGMR_Self_Disclosure_Letter_Template.pdf.

[xi] End-users may wish to exchange draft Questionnaires with their counterparties before adhering to the VM Protocol and exchanging final Questionnaires. Doing so is a way of avoiding the unintended matching of provisions and/or the application of provisions that are elected by one party and do not need to be matched on in order to apply, *e.g.*, the margin regimes being addressed with a particular counterparty.

[xii] *See* note viii, supra.

[xiii] *See, e.g.*, "ISDA Amend faces rival in CSA repapering effort," RISK magazine, December 6, 2016, *available at* http://www.risk.net/risk-magazine/news/2479155/isda-amend-faces-rival-in-csa-repapering-effort (subscription required).

[xiv] Counterparties that use the VM Protocol should be aware of the changes made by the VM Protocol, and ISDA has indicated that market participants can access a list of the terms that have been agreed to via the VM Protocol. However, from a document management perspective, some clients would prefer to have a tailored document that identifies the exact changes made to their existing CSAs.

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