FINAL PHASE OF INITIAL MARGIN REQUIREMENTS FOR UNCLEARED SWAPS TO BE DELAYED UNTIL SEPTEMBER 2021 FOR MOST MARKET PARTICIPANTS–HOW TO MANAGE TIMELINES AND EXPECTATIONS IN LIGHT OF RECENT ACTIONS BY GLOBAL REGULATORS

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Investment Management Alert

SUMMARY

Swap dealers ("SDs") are required to post and collect initial margin ("IM") for uncleared swaps with other SDs and counterparties that are financial end users[1] with "material swap exposure" ("MSE") in accordance with a compliance schedule that has been phasing in for the last three years.[2] The final phase of that implementation, "Phase V," was scheduled to take effect in September 2020 and to result in a substantial number of investment funds and other financial end users coming into the scope of the IM requirements. However, on July 23, 2019, the Basel Committee on Banking Supervision ("BCBS") and the International Organization of Securities Commissions ("IOSCO") issued a statement advising that they have agreed to extend by one year, until September 1, 2021, the final implementation of the IM requirements. The extension is a welcome development given the compliance and documentation issues that have been of concern for many market participants in recent months.[3]

Separately, on July 9, 2019, the CFTC issued a Staff Advisory to make clear to CFTC registrants that documentation requirements pertaining to uncleared swaps (also referred to as "non-centrally cleared derivatives") will not apply until a firm exceeds a $50 million IM threshold for uncleared swaps between a particular SD and counterparty (the "CFTC Advisory").[4]

PRACTICAL IMPLICATIONS

- The practical impact of these two changes is significant for investment funds and other financial end users that trade uncleared swaps.
- Financial end users with a notional amount of non-centrally derivative exposure between €8 billion and €50 billion will enjoy a one-year delay of the effective date of the IM requirements.
- The one-year delay will afford most financial end users and their advisers ample time to assess their exposure to the IM requirements and adjust trading practices accordingly.
- Although the final IM effective date is still more than two years away, financial end users must determine their exposure in the year preceding the upcoming effective date, and a financial end user subject to the

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IM requirements will need to substantially revise derivatives documentation in order to trade derivatives once it becomes subject to the IM requirements.

- The CFTC Advisory provides further relief to financial end users that will ultimately be subject to the IM requirements. As a result of the CFTC Advisory, a counterparty may be able to avoid the onerous documentation process associated with the IM requirements as long as its IM requirement with an SD remains below $50 million.
- This relief will be particularly helpful for financial end users that are deemed to have MSE but that primarily trade instruments (such as FX forwards), which do not create significant IM requirements, and/or enter into limited transactions with certain SDs.

The remainder of this Alert provides details on the regulatory background of margin requirements for uncleared swaps and the impacts of the recent action by BCBS and IOSCO, as well as the CFTC Advisory.

IM EXTENSION NOTICE

In the July 23 notice, BCBS and IOSCO stated that "[t]he final [IM] implementation phase will take place on September 1, 2021, at which point covered entities with an aggregate average notional amount ("AANA") of non-centrally cleared derivatives greater than €8 billion will be subject to the requirements."[5] To facilitate this extension, BCBS and IOSCO introduced an additional implementation phase whereby, as of September 1, 2020, covered entities with an AANA of non-centrally cleared derivatives greater than €50 billion will be subject to the requirements. BCBS and IOSCO provided a summary table to note the changes, which is reproduced below, with changes[6] to the implementation phases in **bold**:

Summary of changes to the implementation of the margin requirements for non-centrally cleared derivatives		
	March 2015 Framework	**July 2019 Revisions**
Initial Margin		
Covered entities belonging to a group whose aggregate month-end average notional amount of non-centrally cleared derivatives exceeds:		
€3.0 trillion	1 September 2016 to 31 August 2017 (based on average notional amounts for March, April, and May 2016)	1 September 2016 to 31 August 2017 (based on average notional amounts for March, April, and May 2016)
€2.25 trillion	1 September 2017 to 31 August 2018 (based on average notional amounts for March, April, and May 2017)	1 September 2017 to 31 August 2018 (based on average notional amounts for March, April, and May 2017)

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€1.5 trillion	1 September 2018 to 31 August 2019 (based on average notional amounts for March, April, and May 2018)	1 September 2018 to 31 August 2019 (based on average notional amounts for March, April, and May 2018)
€0.75 trillion	1 September 2019 to 31 August 2020 (based on average notional amounts for March, April, and May 2019)	1 September 2019 to 31 August 2020 (based on average notional amounts for March, April, and May 2019)
€50.0 billion	**Not applicable**	**1 September 2020 to 31 August 2021 (based on average notional amounts for March, April, and May 2020)**
Covered entities belonging to a group whose aggregate month-end average notional amount of non-centrally cleared derivatives exceeds €8.0 billion	From 1 September 2020 onwards (based on average notional amounts for March, April, and May that year)	**From 1 September 2021 onwards (based on average notional amounts for March, April, and May that year)**

The CFTC and U.S. Prudential Regulators are expected to take action to implement the phases noted above shortly, as are regulators in other developed markets.

CFTC ADVISORY ON IM THRESHOLD

BCBS and IOSCO also issued a statement earlier this year noting that "the framework does not specify documentation, custodial or operational requirements if the bilateral initial margin amount does not exceed the framework's €50 million initial margin threshold," and the recent CFTC Advisory aligns with that statement.[7]

REGULATORY BACKGROUND OF MARGIN REQUIREMENTS

The CFTC Advisory builds on the CFTC's prior regulatory response and that of other financial regulators to the 2008/2009 financial crisis. The Group of Twenty ("G20"), which includes the United States and other countries with the world's largest economies, were in agreement that improved transparency in the over-the-counter ("OTC") derivatives markets and further regulation of OTC derivatives and market participants would be necessary to limit excessive and opaque risk-taking through OTC derivatives and to mitigate the systemic risk posed by OTC derivatives transactions, markets, and practices. The G20 2009 Pittsburgh communiqué initiated a series of reforms to reduce these risks.[8] That G20 communiqué called for Finance Ministers and Central Bank Governors to reach agreement on an international framework to enhance regulation of swaps by requiring that standardized swaps be traded on exchanges or electronic trading platforms, cleared through central counterparties, and reported to trade repositories. In addition, the communiqué indicated that non-centrally cleared contracts "should be subject to higher capital requirements."[9]

In 2011, the G20 further indicated that the BCBS and IOSCO, together with other relevant organizations, should develop margin standards for non-centrally cleared derivatives.[10]

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On behalf of the United States, the CFTC and other regulators participated in a Working Group with BCBS and IOSCO to create an international framework of minimum standards for margin for uncleared swaps.[11] In 2016, the CFTC issued final regulations governing margin requirements for uncleared swaps, which were generally consistent with the international framework.[12]

IMPACT OF THE IM REQUIREMENTS AND ADVISORY

The margin requirements for uncleared swaps may apply where both counterparties are SDs or the counterparties are an SD and a financial end user with MSE. As noted above, financial end users include, among others, private funds, commodity pools, registered investment companies, employee benefit plans, insurance companies, and money services businesses.[13]

SDs are required to post and collect IM with counterparties in accordance with a phased compliance schedule as outlined in CFTC Regulation 23.161. As noted above, BCBS and IOSCO announced on July 23, 2019, that the so-called "Phase V," which was due to take effect on September 1, 2020, has been postponed for a year.[14] Accordingly, on September 1, 2021, financial end users with MSE greater than $8 billion in daily AANA may be required to comply with the IM requirements.[15] As a financial end user counterparty comes within the scope of the IM regulations, an SD is required to execute margin documentation.[16] Under CFTC Regulation 23.154(a)(3), SDs are not required to post or collect IM until the "initial margin threshold amount" has been exceeded. The term "initial margin threshold amount" is defined in CFTC Regulation 23.151 to mean "an aggregate credit exposure of $50 million resulting from all uncleared swaps between an SD and its margin affiliates on the one hand, and a covered counterparty and its margin affiliates on the other." **The Advisory clarifies that documentation governing the posting, collection, and custody of IM is not required to be completed until such time as the IM amount between particular counterparties exceeds $50 million.**

Although the CFTC has indicated that no specific IM documentation is required prior to reaching the $50 million IM threshold, SDs and their counterparties should take appropriate preparatory steps to have the documentation ready upon reaching the IM threshold. CFTC Regulation 23.504 requires SDs to establish, maintain, and follow written policies and procedures reasonably designed to ensure the execution of IM documentation. SDs must also comply with Section 4s(j)(2) of the Commodity Exchange Act and implementing CFTC Regulation 23.600, pursuant to which SDs must establish a risk management system to monitor and manage risk associated with their swap activities, including legal risk, such as the failure to comply with applicable CFTC regulations.[17]

The CFTC Advisory applies only to SDs because the CFTC margin requirements for uncleared swaps do not require financial end users to establish custodial services, document margin relationships, or operationalize the exchange of IM. **Although the regulatory obligations of the CFTC's margin requirements for uncleared swaps are placed directly upon SDs, which must undertake the major share of the preparatory work for such transactions, financial end users will be indirectly impacted by the SD documentation requirements and should not be passive observers of this process.** As necessary, financial end users will have to review and negotiate any credit support, collateral transfer, or custodial arrangement documentation presented by an SD. A financial end user that may be subject to IM requirements may wish to review the IM regulations, including what is acceptable collateral, and consider what steps it may need to take to assure that its systems and operations would be sufficient to assure compliance.

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Based on the recent BCBS and IOSCO announcement, many financial end users will have an additional year to prepare for these new requirements. However, it is not too early for such entities to engage in at least preliminary calculations of whether they would have MSE based upon their swaps activity in 2019, which may be conducted with greater precision during the relevant months of 2020 and 2021. Such exercises will provide entities with a clearer picture of potential exposure and modifications in swap activities to plan for any IM requirements. Financial end users should also be mindful that the demand upon resources of third parties to assist with compliance may increase as Phase V draws nearer in 2020 and 2021.

CONCLUSION

The addition of an intermediate AANA threshold in 2020 and an additional year to comply with the final implementation of IM regulations is a welcome development for those entities that are substantial participants in swap markets. That extension and the CFTC Advisory should provide for a smoother transition to final implementation and greater compliance by market participants, which should be the goals of international regulators. Even though financial end users are not directly impacted by these regulatory pronouncements, those that are active participants in swap markets should use the additional time provided before Phase V becomes effective to prepare for the potential operational changes that could be applicable at that time.

The global futures and derivatives team at K&L Gates continues to follow these and other upcoming developments at the CFTC, including changes to the swaps trading rules, cross-border guidance, and position limits given the arrival of a new Chairman of the CFTC, Heath Tarbert, on July 15, 2019.[18] Our futures and derivatives team stands ready to assist market participants in the navigation of these developments and the new CFTC and global derivatives regulatory agenda.

Notes:

[1] Financial end users are defined broadly in Commodity Futures Trading Commission ("CFTC") Regulation 23.151 as counterparties who are not SDs and are a: bank holding company, depository institution, credit or lending entity, money services business, securities holding company, broker or dealer, investment adviser, registered investment company, private fund, commodity pool, commodity pool operator, commodity trading advisor, floor broker, floor trader, introducing broker, futures commission merchant, employee benefit plan, insurance company, or other enumerated financial firms.

[2] CFTC Regulation 23.161. CFTC regulations referred to in this document may be found in Title 17 of the Code of Federal Regulations.

[3] Phases I–IV have been implemented on an annual basis beginning in 2016. Please see the table below for the full implementation schedule. The delay implementing Phase V does not otherwise impact the parties who are required to post and collect IM to comply with Phases I–IV.

[4] *See* U.S. Commodity Futures Trading Commission, *CFTC Staff Issues Advisory Clarifying $50 Million Initial Margin Threshold and Documentation Requirements* (July 9, 2019),

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https://www.cftc.gov/PressRoom/PressReleases/7960-19?utm_source=govdelivery, which is also denoted as CFTC Letter No. 19-16.

[5] *See* Basel Committee on Banking Supervision and International Organization of Securities Commissions, *Basel Committee and IOSCO agree to one-year extension of the final implementation phase of the margin requirements for non-centrally cleared derivatives* (July 23, 2019), https://www.bis.org/press/p190723.htm.

[6] *See* Basel Committee on Banking Supervision and International Organization of Securities Commissions, *BCBS/IOSCO statement on the final implementation phases of the Margin requirements for non-centrally cleared derivatives* (Mar. 5, 2019), https://www.bis.org/press/p190305a.htm. The table is available at: https://www.bis.org/bcbs/publ/d475_summarytable.pdf.

[7] *See id.*

[8] *See* G20, *G20 Leaders Statement: The Pittsburgh Summit*, Sept. 25, 2009, www.g20.utoronto.ca/2009/2009communique0925.html.

[9] *Id.*

[10] *See* G20, *Cannes Summit Final Declaration – Building Our Common Future: Renewed Collective Action for the Benefit of All*, Nov. 4, 2011, http://www.g20.utoronto.ca/2011/2011-cannes-declaration-111104-en.html.

[11] *See* Office of the Federal Register, *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 81 FR 636 (Jan. 6, 2016), https://www.federalregister.gov/documents/2016/01/06/2015-32320/margin-requirements-for-uncleared-swaps-for-swap-dealers-and-major-swap-participants.

[12] *See* id. The CFTC regulations govern those SDs that are not subject to the requirements of a Prudential Regulator, which is how the U.S. banking regulators are referred to for these purposes. Those SDs with a Prudential Regulator, which include most of the largest SDs, must meet the margin requirements for uncleared swaps set by the applicable Prudential Regulator. The margin requirements of the Prudential Regulators are generally similar to those of the CFTC.

[13] Margin requirements for uncleared swaps do not apply if one of the parties is a commercial end user, such as an energy company or agricultural producer, and is using swaps to hedge or mitigate commercial risk.

[14] *See* Basel Committee on Banking Supervision and International Organization of Securities Commissions, *Basel Committee and IOSCO agree to one-year extension of the final implementation phase of the margin requirements for non-centrally cleared derivatives* (July 23, 2019), https://www.bis.org/press/p190723.htm. The CFTC and Prudential Regulators will have to take action in order to implement this one-year extension.

[15] CFTC Regulation 23.151 defines MSE for an entity to mean that the entity and its margin affiliates have an AANA of uncleared swaps, uncleared security-based swaps, foreign exchange forwards, and foreign exchange swaps with all counterparties for June, July, or August of the previous calendar year that exceeds $8 billion, where such amount is calculated only for business days.

[16] *See* CFTC Regulation 23.158.

[17] *See* 7 U.S.C. § 6c(j)(2).

[18] For example, we previously published an Alert regarding the CFTC providing no-action relief so that investment advisers to large institutions, such as registered investment companies or pension plans, will be

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subject to a minimum transfer amount ("MTA") of margin on uncleared swaps based upon the separately managed account that the adviser is responsible for, rather than having to calculate the MTA across all accounts of the investor.

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