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DERIVATIVES

Hedge Funds Face Increased Margin Requirements Under Final Swap Rules (Part One of Two)

By Fabien Carruzzo and Philip Powers
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On October 22, 2015, five federal agencies adopted a joint final rule establishing minimum initial and variation margin requirements for non-cleared swaps entered into by a registered swap dealer, major swap participant, security-based swap dealer or major security-based swap participant. The U.S. prudential regulators – the FDIC Board of Directors, the Office of the Comptroller of the Currency, the Federal Reserve Board, the Farm Credit Administration and the Federal Housing Finance Agency – adopted this final rule (PR final rule) [1] shortly before the U.S. Commodity Futures and Trading Commission (CFTC) adopted a substantially similar final rule on December 16, 2016, for margin requirements for non-cleared swaps entered into by a registered swap dealer or major swap participant that is not regulated by a U.S. prudential regulator (including non-bank subsidiaries of a bank holding company) (CFTC final rule[2] and, collectively with the PR final rule, the final rules). However, the CFTC final rule materially deviates from the PR final rule in several ways, as noted below.

Importantly, the U.S. prudential regulators and the CFTC each specified (in interim final rules) that the margin requirements do not apply to certain non-cleared swaps and non-cleared security-based swaps of financial institutions with total assets of ten billion dollars or less or commercial end-users that would otherwise be exempt from clearing.[3] The SEC has yet to issue final rules establishing margin requirements for security-based swap dealers and major security-based swap participants that are not regulated by a U.S. prudential regulator.

Hedge funds and other investment funds trading non-cleared swaps with registered swap dealers supervised by either the U.S. prudential regulators or the CFTC (covered swap dealers) will be indirectly impacted by the final rules and will likely face increased costs of trading non-cleared swaps as described below.

In a two-part guest series, Fabien Carruzzo and Philip Powers – partner and associate, respectively, at Kramer Levin – discuss the final rules and analyze their impact on hedge funds.

This first article addresses the calculation of a fund's material swaps exposure, as well as the requirements under the final rules for covered swap dealers to collect and post initial and variation margin with respect to non-cleared swaps with their counterparties. The second article will address minimum transfer amounts; eligible collateral and haircuts; netting of exposure; documentation and industry initiatives; compliance obligations under the final rules; and the practical implications of the final rules on hedge funds. For additional insight from Carruzzo, see "OTC Derivatives Clearing: How Does It Work and What Will Change?" (Jul. 14, 2011). For more from Kramer Levin practitioners, see "'Interval Alts' Combine Benefits of Alternative Mutual Funds and Traditional Hedge Funds" (Jul. 16, 2015).

Material Swaps Exposure

Calculation

A fund has material swaps exposure if it (and its affiliates) have an average daily aggregate notional amount of non-cleared swaps, foreign exchange forwards and foreign exchange swaps for June, July and August of the previous calendar year (calculated only for business days and counting affiliate trades only once) exceeding eight billion dollars.

The material swaps exposure determination applies to a fund for an entire calendar year. Accordingly, material swaps exposure would be calculated each year on January 1 based on June, July, and August of the previous year.

In determining whether a fund has material swaps exposure, the U.S. prudential regulators and CFTC note that it is reasonable for a covered swap dealer to rely in good faith on reasonable representations made by a fund as to whether that fund has material swaps exposure.

Change in Material Swaps Exposure Status

Once the final rules are effective for a fund, if a fund exceeds the material swaps exposure threshold based on June, July

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and August of the previous calendar year, then the stricter margin requirements applicable to a fund with material swaps exposure will apply only for trades entered into after the change in status is effective on January 1 of the following year.

Conversely, if a fund no longer has material swaps exposure based on June, July and August of the previous calendar year, then the less strict margin requirements will apply for all trades, including any outstanding trades at the time the change in status is effective (and any initial margin that had been previously collected would no longer be required under the final rules).

FX Forwards and Swaps

While the average daily notional amount of a fund's foreign exchange forwards and swaps are taken into account for determining whether that fund has material swaps exposure, there is no requirement for a covered swap dealer to collect or post margin with respect to foreign exchange forwards and swaps.

Affiliates

Affiliate determinations in the final rules are largely based on the consolidation of financial statements as opposed to a "control" standard, which was previously proposed by the U.S. prudential regulators and the CFTC. The U.S. prudential regulators (but not the CFTC) also afforded themselves discretion to determine that entities will be deemed to be affiliates for purposes of the PR final rule where either entity provides significant support to, or is materially subject to the risk of losses of, the other entity.

By using the consolidation standard under the final rules, it is largely expected that investing across funds or fund complexes will not create affiliate relationships for purposes of the final rules. Additionally, a fund should not be consolidated with its investment manager other than in certain instances where the manager holds a large portion of the fund, including during a seeding period.

Initial Margin Posting

Initial Margin for Funds With Material Swaps Exposure

With respect to initial margin and a fund with material swaps exposure, a covered swap dealer must both collect and post margin on a daily basis with respect to any non-cleared swap. The amount of margin that is required to be collected and posted must be an amount at least equal to the amount required by either (1) an internal margin model meeting the requirements of the final rules and approved by the relevant U.S. prudential regulator, in the case of the PR final rule, or the CFTC or a registered futures association (e.g., the National Futures Association), in the case of the CFTC final rule; or (2) a standardized formula set forth in the final rules. In any case, a swap dealer may require a fund to post margin in excess of the minimum amount required by the final rules.

The standardized formula is based on the notional amount of the transactions in a non-cleared swap portfolio together with a table setting forth the respective initial margin percentages for types of swaps within that portfolio. The standardized formula recognizes risk offsets by including in the calculation the ratio of the net current replacement cost of the non-cleared swaps in the portfolio to the gross current replacement cost of the non-cleared swaps in the portfolio, if documented under an "eligible master netting agreement" for such swaps.

Segregation of Initial Margin for Funds With Material Swaps Exposure

As between a covered swap dealer and a fund with material swaps exposure, all initial margin that is required to be posted by that swap dealer or fund must be segregated with one or more third-party independent custodians. Any excess initial margin that is posted by a fund with material swaps exposure, however, is not subject to the segregation requirements.

Any required segregation must be made pursuant to a custodial agreement that, among other things, prohibits (1) substituting or reinvesting funds or other property in assets that would not be eligible collateral under the final rules; and (2) lending activities of the custodian, including "rehypothecating, repledging, reusing or otherwise transferring" funds or other property held by the custodian. There is an exception that cash collateral may be held in a general deposit account with the custodian if the funds in the account are used to purchase eligible non-cash collateral within a reasonable time after the cash collateral is posted and that non-cash collateral is then segregated.

Initial Margin for Funds Without Material Swaps Exposure

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With respect to initial margin and any fund without material swaps exposure, under the PR final rule a covered swap dealer must collect (with no requirement to post) initial margin at times and in the forms or amounts (if any) that the covered swap dealer determines appropriately address the credit risk posed by that fund and the risks of the relevant non-cleared swaps. No related requirement exists in the CFTC final rule.

A dealer is not required to segregate any initial margin that it collects from any such fund under the PR final rule, but any amount voluntarily posted by a swap dealer would be required to be segregated as described above.

Initial Margin Transfer Timing and Threshold for All Funds

Initial margin must be posted on or before the first business day following the "day of execution." Where the parties enter into a swap (1) after 4:00 p.m. in the location of a party, the day of execution will be the next business day for both parties; or (2) on a different calendar day in the location of each party, the day of execution will be the later of the calendar days or, if that calendar day is not a business day for a party, the next business day for both parties.

A threshold of up to a $50 million ($20 million where the parties are affiliates under the PR final rule) may be applied to the aggregate credit exposures resulting from all non-cleared swaps between a fund and a covered swap dealer (and their respective affiliates). In that respect, the final rules explicitly note that separate accounts having multiple managers will not receive a separate threshold for each manager of a sleeve of that account despite operational issues that are likely to result.

Variation Margin Posting

With respect to variation margin, regardless of whether a fund has material swaps exposure, a covered swap dealer must both collect and post mark-to-market margin on each business day, for a period beginning on or before the business day following the day of execution and ending on the date of termination/expiry. There is no segregation requirement with respect to variation margin, and no threshold is permitted.

Notably, the CFTC final rule differs from the PR final rule in that respect. The CFTC requires swap dealers (1) to rely on recently-executed transactions, independent third-party valuations or other objective criteria; and (2) to specify in documentation the variation margin methodology with sufficient detail to allow its counterparty or any applicable regulator to independently calculate a reasonable approximation of the margin requirement.

In the case of the PR final rule or the CFTC final rule, for any fund without material swaps exposure, the final rules should not significantly change current practice with respect to its margin posting obligations.

[1] Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 74,839 (Nov. 30, 2015); 12 CFR parts 45, 237, 349, 624 and 1221.
[2] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 635 (Jan. 6, 2016); 17 CFR parts 23 and 140.
[3] Supra notes 1 and 2.

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Derivatives

Hedge Funds Face Increased Trading Costs Under Final Swap Rules (Part Two of Two)

By Fabien Carruzzo and Philip Powers
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The new joint final rule (PR final rule)[1] adopted by the U.S. prudential regulators[2] – establishing minimum initial and variation margin requirements for certain non-cleared swaps – likely means cost increases for hedge funds and other investment funds trading those swaps. Hedge funds face comparable issues under the substantially similar final rule adopted by the U.S. Commodity Futures and Trading Commission (CFTC) for margin requirements for non-cleared swaps entered into by registered swap dealers or major swap participants that are not regulated by a U.S. prudential regulator (CFTC final rule[3] and, collectively with the PR final rule, the final rules).

In a guest two-part series, Fabien Carruzzo and Philip Powers, partner and associate, respectively, at Kramer Levin, discuss these final rules and their impact on hedge funds. This second article explores minimum transfer amounts; eligible collateral and haircuts; netting of exposure; documentation and industry initiatives; compliance obligations; and practical implications of the final rules on hedge funds. The first article focused on calculating a fund's material swaps exposure, as well as the final rules' requirements for collecting and posting initial and variation margin with respect to non-cleared swaps. For more from Kramer Levin practitioners, see "Risks Faced by Hedge Fund Managers That Access the Alternative Mutual Fund Market Via Turnkey Platforms" (Mar. 13, 2014); and "Kramer Levin Partner George Silfen Discusses Challenges Faced by Hedge Fund Managers in Operating and Distributing Alternative Mutual Funds" (Apr. 18, 2013).

Minimum Transfer Amount

The parties to one or more non-cleared swaps can agree to apply a minimum transfer amount such that a covered swap dealer need not collect or post margin from or to a fund unless the combined initial and variation margin that must otherwise be delivered by a party exceeds $500,000 (or such lesser amount agreed by the parties). Given that this amount is applied at the entity level (as opposed the eligible master netting or portfolio level), separately managed accounts acting on behalf of the same legal entity (1) will not receive the benefit of a separate minimum transfer amount; and (2) will be required to allocate this amount across the separately managed accounts.

Eligible Collateral and Haircuts

Eligible Collateral

Eligible collateral for non-cleared swaps between a covered swap dealer and an investment fund includes (1) any G11 currency; (2) the currency of settlement for the non-cleared swap; and (3) certain liquid U.S. or foreign government or corporate debt securities, certain listed equity securities, shares in certain pooled investment vehicles and gold.

Eligible collateral excludes any securities issued by the party to a non-cleared swap that is pledging such collateral (or by its affiliates), as well as securities issued by a bank holding company, a savings and loan holding company and a depositary institution, among others.

Haircuts

Non-cash collateral will be subject to minimum haircuts specified by table in the final rules. An additive eight percent cross-currency haircut applies with respect to variation margin collateral if the collateral is denominated in a currency other than the currency of settlement, except for cash denominated in any G11 currency. An additive eight percent cross-currency haircut applies with respect to initial margin collateral if the collateral is denominated in a currency other than (1) the currency of settlement; or (2) an agreed termination currency under the relevant eligible master netting agreement.

The limitations on eligible collateral and any specified haircuts are not required for any margin collected or posted in excess of the minimum margin required by the final rules.

Netting of Exposures

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In determining exposures, a covered swap dealer may net initial margin requirements on a portfolio basis in certain circumstances where it uses an approved margin model and net variation margin requirements on an aggregate, net basis, in each case for swaps covered by an eligible master netting agreement. However, initial and variation margin amounts may not be netted against each other.

Where parties have only entered into pre-compliance date non-cleared swaps under an eligible master netting agreement, those swaps will not be subject to the final rules. Where the parties have entered into both pre-compliance and post-compliance date swaps under an eligible master netting agreement, the parties may elect to margin the pre-compliance date swaps under a separate netting portfolio from the post-compliance date swaps (which both the U.S. prudential regulators and CFTC note could be documented under separate credit support annexes), with the effect of excluding pre-compliance date swaps from the requirements of the final rules.

Documentation and Industry Initiatives

When facing a fund, a covered swap dealer must execute documentation specifying the methods, procedures, rules and inputs for (1) determining the value of each non-cleared swap for purposes of calculating variation margin requirements; and (2) calculating the amount of initial margin required for each non-cleared swap. Procedures must be specified for disputed valuation of both non-cleared swaps and assets posted as margin. Affected market participants will need to amend their non-cleared swaps documentation before the rule becomes effective to comply with these requirements and those described above.

As noted above, the final rules permit parties to non-cleared swaps to document those swaps in separate portfolios for netting purposes under one eligible master netting agreement. This may result in a fund having several credit support annexes (and, in some instances, segregated collateral accounts) with each of its swap dealers, in addition to documentation for the resolution of disputes and portfolio reconciliation (which may be separately negotiated or potentially agreed by protocol).

Industry Initiatives Related to Documentation

The Legal and Documentation Working Group of the International Swaps and Derivatives Association Inc. (ISDA) expects to publish credit support annexes and credit support deeds (collectively referred to as "credit support documents") that an investment fund can use to facilitate trading with its swap dealers under its existing ISDA master agreements and alongside existing credit support documents. The new credit support documents should be adaptable for use under both New York and English law and should include regulatory compliant initial and variation margin terms for both the PR final rule and the CFTC final rule (in addition to other jurisdictions) covering swaps subject to regulatory margin entered into after the relevant compliance dates.

In addition to publishing the new credit support documentation for use by funds, ISDA expects that a fund will be able to use a protocol method to (1) enter into new credit support documents; (2) amend its existing documents; or (3) replicate and then amend its existing documents.

Effectiveness and Compliance

The final rules become effective on April 1, 2016, and phased-in compliance will occur between September 1, 2016, and September 1, 2020. Margin requirements will be phased in as follows:

Compliance date:	Covered swaps exposure (determined similarly to material swaps exposure but calculated for March, April and May of the same year of the relevant compliance date) exceeds the following for each of (1) a fund and itsaffiliates; and (2) a swap dealer and its affiliates:
Initial margin requirements	
Sep. 1, 2016	$3 trillion
Sep. 1, 2017	$2.25 trillion
Sep. 1, 2018	$1.5 trillion
Sep. 1, 2019	$0.75 trillion
Sep. 1, 2020	All other funds
Variation margin requirements	
Sep. 1, 2016	$3 trillion
Mar. 1, 2017	All other funds

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PR Final Rule Cross-Border Application / Substituted Compliance

The PR final rule does not apply to any "foreign" non-cleared swap of a "foreign covered swap entity." Generally, a foreign non-cleared swap is any non-cleared swap with respect to which none of the fund, the relevant swap dealer and their respective guarantors (if any) are organized under U.S. or State law (including certain branches, agencies or subsidiaries of an entity organized under U.S. or State law, as well as U.S. branches, agencies or subsidiaries of a foreign bank).

In determining a fund's jurisdiction, the PR final rule will look solely to the jurisdiction of organization of that fund and its guarantor(s) (if any) as opposed to relying on a "U.S. person" or a "principal place of business" test. In that respect, compliance with the PR final rule (or substituted compliance with the rules of another jurisdiction) for a fund organized outside of the U.S. and without a U.S. guaranty will largely depend on the regulatory regime to which that fund's swap dealer is subject.

Accordingly, when facing a foreign covered swap entity, that fund will not be subject to the requirements of the PR final rule even where that fund has U.S. investors or a principal place of business in the U.S. by virtue of having a U.S.-based manager.

In addition, the PR final rule provides that, where any such fund has material swaps exposure and the U.S. prudential regulators make a comparability determination for that fund's jurisdiction, a covered swap dealer (including a U.S. swap dealer) may satisfy its obligation to post initial margin to that fund by complying with that foreign jurisdiction's margin collection requirements (provided that the fund is required to collect initial margin under the relevant regulations).

CFTC Final Rule Cross-Border Application

The CFTC final rule does not include provisions relating to its cross-border application. Instead, the CFTC notes in the CFTC final rule that it will address cross-border application in a separate rulemaking, including substituted compliance and exclusions, as appropriate. A proposed rule addressing cross-border application of margin requirements was released by the CFTC on July 14, 2015.[4]

Practical Implications

The final rules will likely increase the cost of trading non-cleared swaps for investment funds due to a number of factors, including both regulatory compliance and funding costs for swap dealers to comply with the documentation, modeling, segregation and, in some instances, collateral posting requirements. These costs will likely be passed on to end-users in the form of higher spreads on their non-cleared swaps trades. The impact on a particular fund will therefore depend to some extent on the relevant trading strategies of the fund and its reliance on non-cleared swaps for leverage and access to liquidity and markets, among other factors.

In addition, increased regulatory burdens (and the associated costs) may cause some dealers to exit markets for certain non-cleared products, which could reduce access to liquidity for some funds. This has been the case with, for example, futures and single-name credit default swaps markets.

However, the funds trading most heavily in derivatives (and therefore the funds most likely to be impacted) must also consider the benefit they will receive in the form of a decrease in counterparty risk to their swap dealers due to the collection of initial margin from those dealers and the required segregation of the fund's initial margin where a fund is not already segregating. This benefit will be pronounced where a fund would be prevented from terminating non-cleared swaps with an insolvent dealer counterparty for a specified period of time due to an applicable regulatory resolution constraint.

An infographic prepared by the authors summarizing the amounts of margin required under the final rules follows this article.

Fabien Carruzzo, head of Kramer Levin's derivatives and structured products group, represents asset managers, hedge funds, mutual funds and other market participants in the full spectrum of transactional and regulatory derivatives and structured products matters. He counsels clients in assessing and mitigating the risks inherent in trading financial products, and advises them on the implementation of regulatory reforms affecting the derivatives and futures industry. Mr. Carruzzo frequently lectures for leading industry associations, including ISDA and FIA, and is recognized as a leading practitioner in the derivatives and structured finance industry.

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funds and investment banks in derivatives trading, prime brokerage and structured repo financing transactions, collateral segregation and similar arrangements, including related regulatory matters.

[1] Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 74,839 (Nov. 30, 2015); 12 CFR parts 45, 237, 349, 624 and 1221.
[2] The U.S. Prudential Regulators comprise the FDIC Board of Directors, the Office of the Comptroller of the Currency, the Federal Reserve Board, the Farm Credit Administration and the Federal Housing Finance Agency.
[3] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 635 (Jan. 6, 2016); 17 CFR Parts 23 and 140.
[4] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants – Cross-Border Application of the Margin Requirements; Proposed Rule, 80 Fed. Reg. 41376 (Jul. 14, 2015).

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How much margin to post? That depends on your swaps exposure

In order to better manage risk in the swaps market, the U.S. prudential regulators ("PR") and the CFTC each issued final rules requiring covered swap dealers to collect and (in some cases) post both initial and variation margin for certain non-cleared swaps. Investment funds trading non-cleared swaps with such dealers may thus face new margin requirements, depending largely on whether or not a fund has "material swaps exposure".

Initial margin

Covered swap dealer must _collect and post_ amount required by rule or approved margin model (except under CFTC rule where there is no such requirement to collect where the fund is an affiliate of the dealer).

Threshold of up to $50m permitted between covered swap dealer and a fund (and their respective affiliates) (but only $20m under PR rule where the fund is an affiliate of the dealer).

Segregation with 3rd-party independent custodian required, subject to limited exceptions for affiliates.

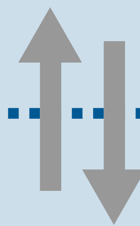
Variation margin

Covered swap dealer must _collect and post_ mark-to-market amount daily.

No threshold permitted.

No segregation required.

Once the final rules are effective for a fund, if a fund exceeds the MSE threshold based on June, July, and August of the previous calendar year, then the stricter margin requirements applicable to a fund with MSE will apply *only for trades entered into after the change in status is effective* on January 1 of the following year.



Material Swaps Exposure (MSE) > $8B*

If a fund no longer has MSE based on June, July, and August of the previous calendar year, then the less strict margin requirements will apply for all trades, *including any outstanding trades at the time the change in status is effective.*

Initial margin

Covered swap dealer must _collect only_ at times and in forms/amounts the dealer determines under the PR rule. There is no related requirement under CFTC rule.

Threshold of up to $50m permitted between covered swap dealer and a fund (and their respective affiliates) (but only $20m under PR rule where the fund is an affiliate of the dealer).

No segregation required for margin posted by fund.

Variation margin

Covered swap dealer must _collect and post_ mark-to-market amount daily.

No threshold permitted.

No segregation required.

Collateral and haircuts

Eligible collateral includes G11 currencies and certain liquid equity and debt securities. Non-cash collateral will have specified haircuts applied based on a table in the final rule. An 8% cross-currency haircut applies in certain circumstances.

*A fund has **material swaps exposure** if it (combined with its affiliates) have an average daily aggregate notional amount of non-cleared swaps, foreign exchange forwards, and foreign exchange swaps for June, July, and August of the previous calendar year (calculated only for business days and counting affiliate trades only once) exceeding $8 billion.

Minimum transfer amount

Parties to one or more non-cleared swaps may agree that a covered swap dealer will not be required to collect or post margin unless the combined initial and variation margin required exceeds $500,000 (or a lesser agreed amount).

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