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MARGIN FOR UNCLEARED SWAPS: PRACTICAL CONSIDERATIONS FOR THE BUY-SIDE

The new U.S. margin regulations for uncleared swaps address the form of margin, timing for delivery, haircuts, required initial and variation amounts, and two-way margin. The authors discuss these subjects and find, in particular, that the regulations will require changes in documentation, and may require adjustments to a buy-side entity's asset mix and operations. They advise buy-side entities to educate themselves on the key parameters of the regulations and make strategic decisions that take regulatory changes into account.

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In the aftermath of the 2008 financial crisis, fundamental regulatory changes were brought to the swaps market, perhaps none touching so many market participants so significantly as the margin requirements for uncleared swaps. Every major jurisdiction has adopted or will adopt margin regulations that impact large banks and other swap dealers, as well as parties on the other side of swap transactions. Compliance dates are staggered, with March 1, 2017 being the first to affect parties other than the largest market participants, and each September 1 through 2020 being additional compliance dates.

The industry has been engaged in an intense effort to modify documentation and put arrangements in place so that transactions would comply with margin requirements before the March 1, 2017 deadline. Swap dealers have invested enormous resources to assure compliance with the regulations by March 1, 2017. However, many other market participants, particularly

those with lean internal staffing, have spent little time digesting the new requirements and understanding their economic and operational effects.¹

¹ Just prior to March 1, 2017, US and European authorities acknowledged that much of the industry would not be compliant with the regulations by the deadline. Each has left an opening for a softer hand in reviewing a swap dealer's compliance with respect to customers that do not pose significant credit and market risk, as long as appropriate risk management processes are in place and the swap dealer is making efforts to comply. Supervision and Regulation Letter 17-3, Board of Governors of the Federal Reserve System (Feb. 22, 2017), <https://www.federalreserve.gov/bankinforeg/srletters/sr1703.pdf>; OCC Bulletin 2017-12, to CEOs and Compliance Officers of National Banks and Federal Savings Associations, Federal Branches and Agencies, Department and Division Heads, All Examining Personnel, and Other Interested Parties (Feb. 23,

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This article discusses some of the practical issues for entities (“buy-side entities”) other than regulated swap entities as the new margin regime is implemented and as their trading relationships go forward. An overview of the margin regulations is provided, but the article does not provide an in-depth description or analysis of the regulations. Where details of the margin rules are needed for context or illustration, the specifics are drawn largely from US regulations. Although the details of the margin regulations vary from jurisdiction to jurisdiction, similar practical considerations are relevant across jurisdictions.

BACKGROUND ON MARGIN REQUIREMENTS

International Framework and Local Laws

Jurisdictions in the Group of Twenty base their regulations regarding margin for uncleared swaps on the margin policy framework (the “Framework”) developed by the Basel Committee on Banking Supervision and the International Organization of Securities Commissions. The Framework, which is spelled out in the *Margin requirements for non-centrally cleared derivatives*, establishes key principles for margin regimes for uncleared swaps.² The Framework’s principles address:

(i) the products subject to margin requirements; (ii) the parties that must collect and/or post margin; (iii) the amount of margin required; (iv) the types of assets that may be used to fulfill margin requirements; (v) haircuts associated with each asset type; (vi) whether and how margin must be segregated; and (vii) the treatment of inter-affiliate transactions. Each jurisdiction must take its own steps to incorporate the principles of the Framework into its laws and regulations.

The US statutory provisions for margin on uncleared swaps are included in Title VII of the Dodd-Frank Act.³ Implementing regulations were adopted by the federal banking regulators (“Prudential Regulators”) in November 2015⁴ for swap dealers, security-based swap dealers, major swap participants and major security-

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Requirements for Non-Centrally Cleared Derivatives (March 2015), <http://www.bis.org/bcbs/publ/d317.pdf>. The Framework was originally released in September 2013, and a revised version was issued in March 2015. The revision was made to delay the implementation schedule for margin requirements.

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2017), <https://www.occ.gov/news-issuances/bulletins/2017/bulletin-2017-12.html>; Press Release, Federal Deposit Insurance Corporation, Agencies Release Swap Margin Guidance (Feb. 23, 2017), <https://www.fdic.gov/news/news/press/2017/pr17013.html>; Eileen T. Flaherty, CFTC No-Action Letter, CFTCLTRNo. 17-11 (Feb. 13, 2017), <http://www.cftc.gov/idc/groups/public/@lrllettergeneral/documents/letter/17-11.pdf>; Statement on Variation Margin Exchange, European Securities and Markets Authority (Feb. 2017), https://www.esma.europa.eu/sites/default/files/library/esas_communication_on_industry_request_on_forbearance_variation_margin_implementation.docx_0.pdf. Because the deadline has not been explicitly reset to a new date (although the US regulators specified September 1, 2017 as the outside date for compliance), pressure to bring trading arrangements and documentation into compliance will continue.

² Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions, *Margin*

³ Pub. L. No. 111-203, 124 Stat. 1376 (2010). The provisions of Dodd-Frank addressing margin are codified as Section 4s(e) of the Commodity Exchange Act, 7 U.S.C. § 6s(e), and Section 15F of the Securities Exchange Act of 1934, 15 U.S.C. § 78o-10, respectively.

⁴ Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 74,840 (November 30, 2015). The Prudential Regulators consist of the Office of the Comptroller of the Currency (“OCC”); the Board of Governors of the Federal Reserve System (“Board”); the Federal Deposit Insurance Corporation (“FDIC”); the Farm Credit Administration (“FCA”); and the Federal Housing Finance Agency (“FHFA”). All the Prudential Regulators adopted the same regulation, which is codified at 12 C.F.R. pt. 45 (2017) for the OCC, 12 C.F.R. pt. 237 (2017) for the Board, 12 C.F.R. pt. 349 (2017) for the FDIC, 12 C.F.R. pt. 624 (2017) for the FCA and 12 C.F.R. pt. 1221 (2017) for the FHFA. Subsequent references to the Prudential Regulators’ regulations cite to the OCC’s regulation only, but the corresponding subpart of the regulation for each of the other four Prudential Regulators is implicit each time.

based swap participants (“Swap Entities”)⁵ subject to the jurisdiction of a Prudential Regulator and by the Commodity Futures Trading Commission in January 2016⁶ for swap dealers and major swap participants not regulated by a Prudential Regulator. The Securities and Exchange Commission issued a proposed rule to cover security-based swap dealers and major security-based swap participants not regulated by a Prudential Regulator, but the SEC’s regulation has not been finalized. The European Union analogue to Title VII of Dodd-Frank is the European Market Infrastructure Regulation,⁷ which is implemented through technical standards adopted by the European Commission.⁸ Legislation has also been adopted or is pending in Japan, Australia, Canada, Switzerland, and other countries.

Key Elements of US Margin Regulations

The US regulations impose margin requirements on uncleared swaps between Swap Entities and “financial end-users.” Swap Entities are considered to be significant participants in the swaps market, either because they are engaged in swap dealing activity or because the level of their swaps activity is sufficiently large that their demise could have a substantial negative impact on the market. Financial end-users include banks, bank holding companies, finance companies, broker-dealers, investment funds, commodity pools, insurance companies, pensions, and other financial

entities that are not Swap Entities.⁹ US regulations don’t dictate margin requirements for uncleared swaps between Swap Entities and non-financial end-users, but instead look to Swap Entities to set requirements for those transactions based on their own credit determinations. Swaps that are uncleared based on the end-user exception from clearing are not subject to US margin regulations.¹⁰

For swaps within scope of the regulations’ margin requirements, the parties are required to exchange variation margin and, in some cases, initial margin. Variation margin must be posted in an amount equal to the mark-to-market value of outstanding swaps, taking into account netting across swaps subject to an eligible master netting agreement.¹¹ The variation margin amount is determined and exchanged on a daily basis.¹² Assets eligible to meet variation margin requirements for swaps between Swap Entities and financial end-users include cash denominated in US dollars, another major currency or the currency in which the swap is settled, certain government securities, certain publicly traded debt securities, certain publicly traded equity securities, and gold.¹³

Initial margin is required for swaps between Swap Entities and financial end-users with “Material Swaps Exposure,” defined as more than \$8 billion of average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange forwards, and foreign exchange swaps for the financial end-user and its affiliates, where the average is taken over the period of June, July, and August of the prior calendar year.¹⁴ The amount of initial margin required may be determined by tables and formulas on the regulations or by an initial margin model approved by the regulators. Eligible assets for initial margin purposes

⁵ Swap dealer and major swap participant are defined at Commodity Exchange Act Sections 1a(49) and 1a(33), codified at 7 U.S.C. § 1a(33), 1a(49) (2017), and at 17 C.F.R. § 1.3(ggg), 1.3(hhh) (2017). Security-based swap dealer and major security-based swap participant are defined at Sections 3(a)(71) and 3(a)(67) of the Securities Exchange Act of 1934, codified at 15 U.S.C § 78c(a)(71), 78c(a)(67) (2017), respectively, and at 17 C.F.R. § 240.3a71-1, 240.3a67-1 (2017).

⁶ Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 635 (January 6, 2016) (codified in 17 C.F.R. § 23.150-161 (2017)).

⁷ Commission Regulation 648/2012 of July 4, 2012, on OTC derivatives, central counterparties, and trade repositories, 2012 O.J. (L 201) (EU).

⁸ Commission Delegated Regulation 2251/2016 of October 4, 2016, supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties, and trade repositories with regard to regulatory technical standards for risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty, 2016 O.J. (L 340) (EU).

⁹ The full definition of financial end-user can be found at 12 C.F.R. § 45.2 (2017); and 17 C.F.R. §23.151 (2017).

¹⁰ 12 C.F.R. 45.1 § (d)(i); C.F.R. § 23.150(b)(1) (2017). Conditions for the end-user exception from clearing are specified in the Commodity Exchange Act, 7 U.S.C. § 2(h)(7) (2017), and 17 C.F.R § 50.50 (2017).

¹¹ 12 C.F.R. § 45.5 (2017); 17 C.F.R. § 23.153, 23.154 (2017).

¹² 12 C.F.R. § 45.4 (2017); 17 C.F.R. § 23.153 (2017).

¹³ 12 C.F.R. § 45.6 (2017); 17 C.F.R. § 23.156 (2017). For swaps between Swap Entities, only cash may be posted as variation margin.

¹⁴ 12 C.F.R. § 45.2 (2017); 17 C.F.R. §23.151 (2017).

are the same as for variation margin.¹⁵ Initial margin must be determined and exchanged on a daily basis.¹⁶

BUY-SIDE ISSUES AS THE MARGIN REGULATIONS ARE IMPLEMENTED

Relationship between Swap Entities and Buy-Side Entities

Before Dodd-Frank and related regulations came into effect, each swap provider had its own standards for collateral and credit support.¹⁷ Broad similarities existed amongst many swap providers, but the details differed from swap provider to swap provider and buy-side entity to buy-side entity. A swap provider often took time to educate buy-side entities on an individual basis and, depending upon the buy-side entity, the swap provider might display willingness to consider requests for changes to its usual approach and to make adjustments as the buy-side entity's situation changed. As a result, buy-side entities would often negotiate arrangements that addressed the nuances of its circumstances.

Although hand-holding and flexibility in negotiations on the part of Swap Entities has been on the decline in general since the financial crisis and the enactment of Dodd-Frank, the decline has become more evident in the face of the new margin regulations. To a buy-side entity, the approach may feel like the Swap Entity is putting its own interest and its concern for regulatory matters ahead of the customer relationship. The apparent change in Swap Entities' attitudes towards customer relationships is not unjustified, however, at least in the short term. The margin rules are directed at Swap Entities, and they must live within the structure imposed by the regulations (although Swap Entities can be stricter than the regulations by, for example, requiring margin in excess of the regulatory requirements and by narrowing the types of assets that may be posted for margin). If a Swap Entity trades after a compliance deadline without having necessary elements in place, it will be in violation of regulations and may be subject to consequences. The enormity of the effort to make necessary changes in documentation and operations in order to achieve compliance with regulatory

requirements across all trading relationships by the regulatory deadlines limits a Swap Entity's ability to make accommodations. If documentation and trading arrangements with a customer are not consistent with regulatory requirements by the deadline, the Swap Entity's only option may be to stop trading with the customer.¹⁸

The buy-side entity can and should position itself to make the best of what may appear to be a difficult situation by educating itself on the key parameters of the margin regulations and making strategic decisions that take the regulatory changes into account. It may have to decide, at least in the short term, whether insisting on a particular point is worth a cessation in trading if documentation is not complete by the regulatory deadline. A buy-side entity should also seek to understand the constraints under which Swap Entities are operating and the points on which the Swap Entities may have more flexibility, particularly after each market-wide deadline recedes in the rear view mirror. On issues of importance to a buy-side entity, it should assert its position now and continue to press for the changes it wants, even if a Swap Entity will not make the requested change at this time. The buy-side entity can acknowledge the Swap Entity's current challenges and make clear it will request a reconsideration of key issues at a later date, so as not to create the impression the buy-side entity is satisfied with the documents and the arrangements.

Form of Margin

Before the US margin regulations came into effect, cash and government securities were the most common forms of collateral permitted under Credit Support Annexes. Depending upon the nature of the buy-side entity's portfolio and its trading, other forms of eligible collateral might be agreed upon with the swap provider, including agency securities and equities. What counted as eligible collateral would be based on the swap provider's credit determination and internal policies, and the negotiation between the parties.

As noted earlier, eligible margin for uncleared swaps between a Swap Entity and a financial end-user may take a number of forms under US regulations. Despite the range of assets allowed under the regulations, some Swap Entities want margin to be in the form of cash

¹⁵ 12 C.F.R. § 45.6 (2017); 17 C.F.R. §23.156 (2017).

¹⁶ 12 C.F.R. § 45.3 (2017); 17 C.F.R. §23.152 (2017).

¹⁷ The terms "swap provider" and "collateral" are used instead of "Swap Entity" and "margin" in discussing swaps engaged in before the implementation of Dodd-Frank, because registered Swap Entity and margin for uncleared swaps are concepts introduced by Dodd-Frank.

¹⁸ Although regulatory authorities have softened their stance towards the March 1, 2017 deadline, the cessation of trading by a Swap Entity with its customer remains a possibility because a new market-wide deadline has not been established and regulatory authorities have made known their expectation for Swap Entities' continued efforts towards compliance.

only, sometimes solely US dollars. Cash margin may be preferable to Swap Entities for capital purposes and other issues outside the margin regulations, or because cash margin has greater flexibility and is easier to value, among other reasons. A buy-side entity that wants to retain the option for posting non-cash margin should press its position. The Swap Entity may soften its stance, particularly if enough customers make that request.

Timing for Delivery of Margin

US regulations require that the initial and variation margin requirements be met within one day of execution of a swap transaction and on a daily basis thereafter.¹⁹ The short time period in which to provide margin poses a number of practical concerns for participants in the swaps market.

First, securities with a normal settlement cycle exceeding one business day may not satisfy margin calls. Market participants, including buy-side entities, may have to make adjustments in their asset mix to assure they have a greater percentage of assets with settlement cycles of one business day or less. Assets with longer settlement cycles can be used as margin, but only through substitution for other assets that have already been posted to meet margin calls. Second, trading relationships that allow for rehypothecation of collateral should be examined to determine whether rehypothecated assets can be returned quickly enough so they are available to meet margin calls for uncleared swaps. Changes may be necessary in those rehypothecation arrangements to assure sufficient availability of assets for swap margin. Third, buy-side entities should determine if differences between its time zone and the time zone of the Swap Entity will make it more difficult to post within one business day and whether it needs to make changes in its choice of asset mix or its operations to assure posting in a timely fashion. Some entities may choose to leave excess securities in account with a custodian or with the other party to the swap so that margin calls can be met on an expedited basis.

Although the Prudential Regulators and the CFTC recognized some of the difficulties for market participants who would have to post margin within one business day, they chose not to accommodate those concerns, instead expecting that market participants would adjust their business habits and processes as

necessary to assure compliance with the accelerated timing requirements for margin.²⁰ To some extent, the timing concerns are addressed by the regulation's making practical accommodations for differences between the parties' time zones and business days.²¹

Haircuts

Haircuts refer to the deduction off the market value of an asset in determining its contribution to margin.²² Haircuts can be a factor in a party's decision regarding which assets it will post to meet collateral or margin requirements, since higher haircuts mean that a greater amount of assets (based on market value) will be required. Prior to the margin regulations, haircuts were determined by agreement between the parties. In a trading relationship between a buy-side entity and a significant swap provider, haircuts were largely dictated by the swap provider, with specific haircuts being based on the nature of the asset posted as collateral, its remaining maturity, and other factors. Although there are similarities in haircuts from one swap provider to the next, each swap provider used its own formulation. A buy-side entity might press for more favorable haircuts to reduce assets to be used as margin and to achieve uniformity in all its trading relationships. In some cases, the swap provider would be willing to negotiate haircuts, although the flexibility was often quite limited.

The new margin regulations specify haircuts based on the asset type and, for debt securities, the remaining maturity. Cash has a zero haircut (cash is valued at 100%), and haircuts on debt securities range from 0.5% to 8.0%. For equity securities, the haircut is either 15% or 25%, and gold is assigned a haircut of 15%.²³ To account for foreign currency risk, an additional 8% haircut is imposed for margin that is not denominated in US dollars or another major currency, or the currency of

¹⁹ 12 C.F.R. § 45.3, 45.4 (2017); 17 C.F.R. § 23.152, 23.153 (2017).

²⁰ Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 74,840, 74,865 (November 30, 2015); Margin Requirements for Uncleared Swaps for Swap Dealers Major Swap Participants, 81 Fed. Reg. 635, 649 (January 6, 2016).

²¹ See definition of *day of execution*, Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. at 74864, codified at 12 C.F.R. § 45.2 (2017); 17 C.F.R. § 23.151 (2017).

²² ISDA's Credit Support Annex uses the concept of a Valuation Percentage to address the same concept as haircuts.

²³ Margin Values for Eligible Noncash Margin Collateral, 12 C.F.R. pt. 45 app. B (2017); 17 C.F.R. §23.156 (2017).

settlement for the uncleared swap.²⁴ A buy-side entity planning to post non-cash margin (assuming the Swap Entity permits non-cash margin) should determine whether the regulatory haircuts are greater than the corresponding haircuts under its pre-regulation Credit Support Annexes and, if so, whether its preference for non-cash margin justifies the additional assets that will have to be posted as a result.

Amount of Margin Required

Variation Margin. Under the US regulations, variation margin is determined on the basis of the mark-to-market value of the transaction.²⁵ That approach does not represent a significant divergence from variation margin under most pre-regulation Credit Support Annexes. However, buy-side entities used to a threshold mark-to-market value below which no margin is required will have to make an adjustment, because the US regulations do not permit a margin threshold. Parties may agree to a minimum transfer amount of up to \$500,000 under the regulations.²⁶ Minimum transfer amounts under pre-regulatory arrangements do not typically exceed \$500,000 for a buy-side entity that is not a dominant market player, so the \$500,000 ceiling on minimum transfer amount in the US regulations will not likely impact buy-side entities significantly.

Initial Margin. As noted earlier, although variation margin will apply to all buy-side entities that are financial end-users, initial margin only applies if the financial end-user has material swaps exposure.²⁷ Initial margin amounts can be determined on the basis of the formula and table in the regulation or on the basis of a model approved by the regulators.²⁸ The International Swaps and Derivatives Association (“ISDA”), the

leading trade association for the swaps industry, has developed the Standard Initial Margin Model (“SIMM”), which will likely be the prevailing method for determining initial margin amounts. ISDA received regulatory approval for SIMM shortly before September 1, 2016 (the compliance date for the largest market players), although the approval included requests from the regulators for further enhancements to the model.

Details regarding SIMM are available to market participants on ISDA’s website.²⁹ ISDA licenses the model for an annual fee covering the cost of maintaining the model and adjustments that keep the model current with regulatory standards. For many swap dealers, paying the SIMM licensing fees will be part of their cost of doing business. Buy-side entities subject to the initial margin requirements may not want to pay the licensing fee and commit the financial, technological, and human resources necessary to understand the complexities of the model and to run it. Regulatory margin requirements are minimum requirements, and a Swap Entity can look for more than the minimum. However, a buy-side entity may want to know what the model dictates for initial margin to help it push for the lowest possible initial margin posted so as to maximize assets invested for investors’ benefit. Third-party vendors making and verifying SIMM calculations are one way for buy-side entities to confirm initial margin amounts without undue expense. Because compliance with the initial margin requirement is phased in, with the next compliance date being September 1, 2017, buy-side entities have some time to consider the most sensible option.

Two-Way Margin

Variation Margin. Before the regulations came into effect, often only the buy-side entity posted collateral, particularly where the buy-side entity was small or newly formed. The swap provider would require the buy-side entity to post margin when the market turned against the buy-side entity, but the swap provider would not have to post collateral when the market moved in the other direction. The US margin regulations impose variation margin requirements on both parties.³⁰ Some buy-side entities used to one-way collateral relationships may at first prefer not to collect margin, despite the additional credit protection it affords, because they don’t have the necessary processes and arrangements in place. However, the regulations require Swap Entities to post

²⁴ 12 C.F.R. § 45.6(c) (2017); 17 C.F.R. § 23.156(b)(2)(i)(A) (2017).

²⁵ See definition of *variation margin amount*, Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. at 74902, codified at 12 C.F.R. § 45.2 (2017); 17 C.F.R. § 23.151 (2017).

²⁶ 12 C.F.R. § 45.5 (2017); 17 C.F.R. § 23.153, 23.154 (2017).

²⁷ One anomaly to note under the US regulations is that margin does not apply to foreign exchange forwards and foreign exchange swaps, but those amounts are included in determining whether the materials swaps exposure threshold has been reached. A party could have very limited swaps trading, but because of extensive foreign exchange transactions it may end up having to post initial margin.

²⁸ 12 C.F.R. § 45.8 (2017); 17 C.F.R. § 23.154 (2017).

²⁹ Available at <https://www2.isda.org/functional-areas/wgmr-implementation/> (last visited Jan. 18, 2017).

³⁰ 12 C.F.R. § 45.4 (2017); 17 C.F.R. § 23.153 (2017).

variation margin, meaning each buy-side entity covered by the requirement will have to consider and determine the arrangement that suits it best if it wants to continue engaging in uncleared swaps. The regulation does not prohibit variation margin posted by the Swap Entity from being held in an account with the Swap Entity, and that may be the most expeditious approach for the buy-side entity, at least for a period of time after the commencement of two-way margin.³¹ The buy-side entity can then determine whether it wants to hold margin posted to it at a third party and whether it wants to exercise its right to rehypothecate the margin (subject to the obligation to return as the market shifts away from it).

Initial Margin. Initial margin may not be rehypothecated and must be held with a custodian that is unaffiliated with either party.³² The segregation requirement is more difficult to put in place than the requirement to collect variation margin, and the parties will need time to negotiate the related custodial agreement. As a practical matter, however, the initial margin segregation requirement may not have an overwhelming effect on buy-side entities. The requirement will only apply to buy-side entities with transaction levels above the material swaps exposure threshold, and larger buy-side entities are more likely than small entities to have existing custodial relationships through which the initial margin segregation arrangements can be established.

Documentation

Documenting arrangements for meeting regulatory margin requirements has raised and will continue to raise a host of practical issues for buy-side participants. As a starting point, Swap Entities must determine the extent to which margin requirements apply to a particular trading relationship, which in turn means they need information on the nature of each customer and the extent of trading by the customer and its affiliates. The specific information needed varies from jurisdiction to jurisdiction based on the laws of the particular jurisdiction. ISDA has developed a Regulatory Margin Self-Disclosure Letter to assist Swap Entities obtain the necessary information.³³ Swap Entities may ask their

buy-side customers to complete the Self-Disclosure Letter for all jurisdictions relevant to the trading relationship. The buy-side entity will need to research and become familiar with pertinent aspects of law in each jurisdiction in order to complete the selections in the Self-Disclosure Letter. As a result, buy-side entities effectively become burdened with learning the laws and regulations directed at Swap Entities. The buy-side entity should be careful not to indemnify the Swap Entity for the buy-side entity's interpretation or understanding of local regulations.

Once it is determined which aspects of margin regulations are applicable in each jurisdiction, Credit Support Annexes or analogous documentation must be brought into compliance with the regulations. ISDA's solution to the market-wide documentation changes necessitated by the margin requirements is its 2016 Variation Margin Protocol (the "VM Protocol"), which effects amendments to address multiple jurisdictions and multiple scenarios in one tool.³⁴ Although the VM Protocol has the advantage of being flexible enough to cover many jurisdictions and situations and to accommodate a vast array of choices made between parties, many market participants are unwilling to undertake the task of sorting through the overwhelming complexity of the tool and to take the risk of inadvertently agreeing to margin arrangements they do not understand and with which they cannot comply.

Other than perhaps the largest of buy-side entities that have extensive trading relationships touching a wide variety of jurisdictions, buy-side entities are generally

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(last visited Jan. 18, 2017). The Regulatory Margin Self-Disclosure Letter covers Canada, the European Union, Japan, Switzerland, and the US. ISDA has also published supplements for Australia, Hong Kong, and Singapore, and will continue to publish supplements for additional jurisdictions as relevant regulations are finalized.

³⁴ Available at <http://www2.isda.org/functional-areas/wgmr-implementation/isda-2016-variation-margin-protocol> (last visited Jan. 18, 2017). The VM Protocol allows the parties to agree to retain their existing Credit Support Annex for swaps entered into before the compliance date for variation margin, and enter into a new Credit Support Annex for new swaps, rather than having a new (or amended) Credit Support Annex cover all transactions. That approach keeps calculations and permitted collateral for existing transactions outside the margin requirement and restrictions in the regulations, but also precludes netting for margin calculations between the two groups of transactions.

³¹ Variation margin posted by some market participants (for example, investment companies regulated under the Investment Company Act of 1940) must be segregated and cannot be rehypothecated.

³² 12 C.F.R. § 45.7 (2017); 17 C.F.R. § 23.157 (2017).

³³ Available at <http://www2.isda.org/functional-areas/wgmr-implementation/isda-regulatory-margin-self-disclosure-letter/>

electing to use bilateral alternatives to the VM Protocol whenever possible. Many Swap Entities are making those alternatives available. Because each Swap Entity prepares its own version of a bilateral alternative to the VM Protocol, a buy-side entity choosing bilateral alternatives will have to review each Swap Entity's document separately. A buy-side entity will have to consider whether the extent of its swap trading relationships justifies the cost and effort needed to become comfortable with the VM Protocol as compared to the resources needed to review a number of bilateral documents.

Choosing between the VM Protocol and bilateral alternatives will be important for some buy-side entities, even though the March 1, 2017 deadline has passed, if they do not expect to trade for a period of time after that date and can amend their Credit Support Annexes after the March 1 market rush is over.³⁵ In addition, as compliance dates approach in other jurisdictions, parties will have to amend documentation for consistency with the laws of the additional jurisdictions.

ISDA is pushing for more standardization and automation of documentation and less negotiation. In its recent whitepaper, *The Future of Derivatives Processing and Market Infrastructure*, ISDA recommended those priorities to achieve greater efficiency in documentation.³⁶ The whitepaper refers to a "check-the-box" approach to selecting documentation terms and to an automated process for production of documentation. The efficiency of that kind of approach may be helpful in meeting massive, market-wide deadlines such as the variation margin deadline, but it has the distinct disadvantage of limiting the ability to address nuances and circumstances unique to a particular market participant, which will be particularly problematic for buy-side entities.

Buy-side entities should be careful to review and understand the documentation covering their trading relationships and margin arrangements. Flaws in the automation process can result in documentation that contains mistakes or leads to misunderstandings between

the parties, resulting in costly disputes. The provider of the technology that implements the automated process is not likely to take responsibility for errors or lack of clarity in documentation. In addition, even if negotiation is not possible, the buy-side entity should prepare its own succinct summary of key credit and operational points to minimize inadvertent defaults and potential domino effects on its broader trading relationships. Finally, as noted previously, if a buy-side entity makes an accommodation in order to help a Swap Entity meet a regulatory deadline or because the Swap Entity insists on using an automated documentation process, the buy-side entity should continue to be vocal about its dissatisfaction and press for an amendment.

Cross-border Issues

Although each of the G-20 jurisdictions started with the same foundation for its regulations on margin for uncleared swaps, as outlined in the Framework, each jurisdiction fleshed out the Framework's principles in a unique fashion. As a result, conclusions regarding the application of margin regulations in one jurisdiction cannot automatically be carried through to another jurisdiction. Even with clarity as to which jurisdiction's regulations apply for particular cross-border transactions, buy-side entities will need some understanding of the regulations for jurisdictions other than their own for reasons noted earlier. For buy-side entities with large enough swap portfolios, differences in the details of margin regulations from one jurisdiction to another could be a factor in the buy-side entity's choice of Swap Entity.

CONCLUSION

Implementation of regulations for margin on uncleared swaps is a major step in building the legal and regulatory structure for the swaps market. Although the regulations are directed to Swap Entities, all market participants engaging in uncleared swaps are impacted unless subject to a specific exception. Initial compliance with variation margin requirements is an important milestone in the market for uncleared swaps, but it is just a first step. Buy-side entities must continue to understand margin regulations of relevant jurisdictions and be aware of the provisions and pitfalls in their documentation. The additional complexity presented by the new margin requirements along with realignment in the swaps industry, growth of new technology solutions and regulatory adjustments will present important challenges for buy-side entities for the foreseeable future. ■

³⁵ The same applies for other buy-side entities with which a swap dealer is comfortable completing margin documentation after March 1, 2017 based on the regulatory authorities' softer approach towards the initial date for compliance.

³⁶ International Swaps and Derivatives Association, *ISDA Whitepaper: The Future of Derivatives Processing and Market Infrastructure* (September 2016), <https://www2.isda.org/functional-areas/infrastructure-management/market-infrastructure-and-technology/>.