

# Proposed Rules

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This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

## COMMODITY FUTURES TRADING COMMISSION

### 17 CFR Part 23

RIN 3038—AC97

### Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants

**AGENCY:** Commodity Futures Trading Commission.

**ACTION:** Notice of proposed rulemaking.

**SUMMARY:** The Commodity Futures Trading Commission (“Commission” or “CFTC”) is proposing regulations to implement new statutory provisions enacted by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”). The proposed regulations would implement the new statutory framework of Section 4s(e) of the Commodity Exchange Act (“CEA”), added by Section 731 of the Dodd-Frank Act, which requires the Commission to adopt capital and initial and variation margin requirements for certain swap dealers (“SDs”) and major swap participants (“MSPs”). The proposed rules address initial and variation margin requirements for SDs and MSPs. The proposed rules will not impose margin requirements on non-financial end users. The Commission will propose rules regarding capital requirements for SDs and MSPs at a later date. The Commission will align the comment periods of these two proposals so that commenters will have an opportunity to review each before commenting on either.

**DATES:** Comments must be received on or before June 27, 2011.

**ADDRESSES:** You may submit comments, identified by RIN 3038–AC97, and Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants by any of the following methods:

- Agency Web site, via its Comments Online process at <http://comments.cftc.gov>. Follow the

instructions for submitting comments through the Web site.

- **Mail:** Send to David A. Stawick, Secretary, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW., Washington, DC 20581.

- **Hand Delivery/Courier:** Same as mail above.

- **Federal eRulemaking Portal:** <http://www.regulations.gov>. Follow the instructions for submitting comments.

Please submit your comments using only one method.

All comments must be submitted in English, or if not, accompanied by an English translation. Comments will be posted as received to <http://www.cftc.gov>. You should submit only information that you wish to make available publicly. If you wish the Commission to consider information that may be exempt from disclosure under the Freedom of Information Act, a petition for confidential treatment of the exempt information may be submitted according to the established procedures in § 145.9 of the Commission’s regulation, 17 CFR 145.9.

The Commission reserves the right, but shall have no obligation, to review, pre-screen, filter, redact, refuse or remove any or all of your submission from <http://www.cftc.gov> that it may deem to be inappropriate for publication, such as obscene language. All submissions that have been redacted or removed that contain comments on the merits of the rulemaking will be retained in the public comment file and will be considered as required under the Administrative Procedure Act and other applicable laws, and may be accessible under the Freedom of Information Act.

**FOR FURTHER INFORMATION CONTACT:** John C. Lawton, Deputy Director, Thomas Smith, Deputy Director, or Thelma Diaz, Associate Director, Division of Clearing and Intermediary Oversight, 1155 21st Street, NW., Washington, DC 20581. Telephone number: 202–418–5480 and electronic mail: [jlawton@cftc.gov](mailto:jlawton@cftc.gov); [tsmith@cftc.gov](mailto:tsmith@cftc.gov); or [tdiaz@cftc.gov](mailto:tdiaz@cftc.gov).

#### SUPPLEMENTARY INFORMATION:

## I. Background

### A. Legislation Requiring Rulemaking for Margin Requirements of SDs and MSPs

On July 21, 2010, President Obama signed the Dodd-Frank Act.<sup>1</sup> Title VII of the Dodd-Frank Act amended the CEA<sup>2</sup> to establish a comprehensive regulatory framework to reduce risk, increase transparency, and promote market integrity within the financial system by, among other things: (1) Providing for the registration and comprehensive regulation of SDs and MSPs; (2) imposing clearing and trade execution requirements on standardized derivative products; (3) creating rigorous recordkeeping and real-time reporting regimes; and (4) enhancing the Commission’s rulemaking and enforcement authorities with respect to all registered entities and intermediaries subject to the Commission’s oversight.

The legislative mandate to establish registration and regulatory requirements for SDs and MSPs appears in Section 731 of the Dodd-Frank Act, which adds a new Section 4s to the CEA. Section 4s(e) explicitly requires the adoption of rules establishing margin requirements for SDs and MSPs, and applies a bifurcated approach that requires each SD and MSP for which there is a prudential regulator to meet margin requirements established by the applicable prudential regulator, and each SD and MSP for which there is no prudential regulator to comply with Commission’s regulations governing margin.

The term “prudential regulator” is defined in a new paragraph 39 of the definitions set forth in Section 1a of the CEA, as amended by Section 721 of the Dodd-Frank Act. This definition includes the Federal Reserve Board; the Office of the Comptroller of the Currency (“OCC”); the Federal Deposit Insurance Corporation (“FDIC”); the Farm Credit Administration; and the Federal Housing Finance Agency. The definition also specifies the entities for which these agencies act as prudential regulators, and these consist generally of Federally insured deposit institutions, farm credit banks, Federal home loan banks, the Federal Home Loan Mortgage

<sup>1</sup> See Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (2010). The text of the Dodd-Frank Act may be accessed at <http://www.cftc.gov/LawRegulation/OTCDERIVATIVES/index.htm>.

<sup>2</sup> 7 U.S.C. 1 et seq.

Corporation, and the Federal National Mortgage Association. In the case of the Federal Reserve Board, it is the prudential regulator not only for certain banks, but also for bank holding companies and any foreign banks treated as bank holding companies. The Federal Reserve Board also is the prudential regulator for subsidiaries of these bank holding companies and foreign banks, but excluding their nonbank subsidiaries that are required to be registered with the Commission as a SD or MSP.

In general, therefore, the Commission is required to establish margin requirements for all registered SDs and MSPs that are not banks, including nonbank subsidiaries of bank holding companies regulated by the Federal Reserve Board. In addition, certain swap activities currently engaged in by banks may be conducted in such nonbank subsidiaries and affiliates as a result of the prohibition on Federal assistance to swap entities under Section 716 of the Dodd-Frank Act. Generally, insured depository institutions ("IDIs") that are required to register as SDs may be required to comply with Section 716 by "pushing-out" to an affiliate all swap trading activities with the exception of: (1) The IDI's hedging or other similar risk mitigating activities directly related to the IDI's activities; and (2) the IDI acting as a SD for swaps involving rates or reference assets that are permissible for investment under banking law.

#### *B. Considerations for SD and MSP Rulemaking Specified in Section 4(s)*

Section 4s(e)(3)(A) states the need to offset the greater risk that swaps that are not cleared pose to SDs, MSPs, and the financial system, and directs the Commission, United States Securities and Exchange Commission ("SEC"), and prudential regulators to adopt capital and margin requirements that: (1) Help ensure the safety and soundness of the registrant; and (2) are appropriate for the risk associated with the uncleared swaps they hold. Section 4s(e)(3)(C) permits the use of noncash collateral, as the Commission and the prudential regulators each determines to be consistent with: (1) Preserving the financial integrity of markets trading swaps; and (2) preserving the stability of the United States financial system.

#### *C. Consultation With SEC and Prudential Regulators*

The Commission has worked closely with the prudential regulators and the SEC in designing these rules. Every effort has been made to be as consistent as possible with the rules being considered by the prudential

authorities. Section 4s(e)(3)(D) of the CEA requires that the Commission, SEC, and prudential regulators (together, referred to as "Agencies") establish and maintain, to the maximum extent practicable, comparable minimum initial and variation margin requirements for SDs, MSPs, security-based swap dealers ("SSDs") and major security-based swap participants ("MSSPs") (together, referred to as "swap registrants"). Section 4s(e)(3)(D) also requires the Agencies to periodically, but not less frequently than annually, consult on minimum margin requirements for swap registrants. As directed by Dodd-Frank, and consistent with precedent for harmonizing where practicable the minimum margin requirements of dual registrants, staff from each of the Agencies has had the opportunity to provide oral and written comments on the proposal and the proposed regulations incorporate elements of the comments provided.

#### *D. Structure and Approach*

Consistent with the objectives set forth above, this release summarizes regulations that the Commission proposes in order to establish minimum initial and variation margin requirements for SDs and MSPs that are not banks. As noted in previous proposed rulemaking issued by the Commission, the Commission intends, where practicable, to consolidate regulations implementing Section 4s of CEA in a new Part 23.<sup>3</sup> By this **Federal Register** release, the Commission is proposing to adopt Subpart E of Part 23, pertaining to the capital and margin requirements and related financial condition reporting requirements of SDs and MSPs.<sup>4</sup>

## **II. Proposed Margin Regulations**

### *A. Introduction*

Section 4s(e)(2)(B) of the CEA provides that:

The Commission shall adopt rules for swap dealers and major swap participants, with respect to their activities as a swap dealer or major swap participant, for which there is not a prudential regulator imposing—

- (i) Capital requirements; and
- (ii) Both initial and variation margin requirements on all swaps that are not cleared by a registered derivatives clearing organization.

Section 4s(e)(3)(A) of the CEA provides that:

To offset the greater risk to the swap dealer or major swap participant and the financial system arising from the use of swaps that are not cleared, the requirements imposed under paragraph (2) shall

- (i) Help ensure the safety and soundness of the swap dealer or major swap participant; and
- (ii) Be appropriate for the risk associated with the non-cleared swaps.

During the recent financial crisis, derivatives clearing organizations ("DCOs") met all their obligations without any financial infusions from the government. By contrast, significant sums were expended as the result of losses incurred in connection with uncleared swaps, most notably at AIG. A key reason for this difference is that DCOs all use variation margin and initial margin as the centerpiece of their risk management programs while these tools were often not used in connection with uncleared swaps. Consequently, in designing the proposed margin rules for uncleared swaps, the Commission has built upon the sound practices for risk management employed by central counterparties for decades.

Variation margin entails marking open positions to their current market value each day and transferring funds between the parties to reflect any change in value since the previous time the positions were marked. This process prevents losses from accumulating over time and thereby reduces both the chance of default and the size of any default should one occur.

Initial margin serves as a performance bond against potential future losses. If a party fails to meet its obligation to pay variation margin, resulting in a default, the other party may use initial margin to cover most or all of any loss based on the need to replace the open position.

Well-designed margin systems protect both parties to a trade as well as the overall financial system. They serve both as a check on risk-taking that might exceed a party's financial capacity and as a resource that can limit losses when there is a failure.

The statutory provisions cited above reflect Congressional recognition that (i) margin is an essential risk-management tool and (ii) uncleared swaps pose greater risks than cleared swaps. In particular, it is noteworthy that Section 4s(e)(2)(B)(ii) requires both variation margin and initial margin for SDs and MSPs on *all* uncleared swaps and that Section 4s(e)(3)(A) explicitly refers to the *greater risk* of uncleared swaps. In addition to the disciplines of regular collection of initial and variation margin previously mentioned, central clearing

<sup>3</sup> See 75 FR 71379 (Nov. 23, 2010).

<sup>4</sup> As noted above, the Commission will propose rules related to capital and financial condition reporting in a separate release.

provides additional means of risk mitigation.

First, unlike an SD or MSP, a DCO is not in the business of taking positions in the market. By definition, a DCO runs a perfectly matched book. Second, a DCO only deals with members who must meet certain financial, risk management, and operational standards. Third, a DCO may turn to those members to help liquidate or transfer open positions in the event of a member default. Fourth, DCOs typically, by rule, have the ability to mutualize a portion of the tail risk associated with a clearing member default through the use of guarantee funds and similar mechanisms.

Concern has been expressed that the imposition of margin requirements on uncleared swaps will be very costly for SDs and MSPs. However, margin has been, and will continue to be, required for all cleared products. Given the Congressional reference to the “greater risk” of uncleared swaps and the requirement that margin for such swaps “be appropriate for the risk,” the Commission believes that establishing margin requirements for uncleared swaps that are at least as stringent as those for cleared swaps is necessary to fulfill the statutory mandate. Within these statutory bounds the Commission has endeavored to limit costs appropriately. For example, as discussed below, the proposal would permit margin reductions for positions with offsetting risk characteristics.

The proposals set forth below were developed in consultation with the prudential regulators. They are consistent in almost all material respects with provisions that the Commission understands are being proposed by the prudential regulators.<sup>5</sup> Salient differences will be noted below.

The discussion below addresses:

(i) The products covered by the proposed rules; (ii) the market participants covered by the proposed rules; (iii) permissible methods of calculating initial margin; (iv) permissible methods of calculating variation margin; (v) permissible margin assets; and (vi) permissible custodial arrangements.

### B. Products

The proposal would cover only swaps executed after the effective date of the regulation that are not cleared by a DCO. The proposal would not apply to swaps executed before the effective date of the final regulation. The Commission

believes that the pricing of existing swaps reflects the credit arrangements under which they were executed and that it would be unfair to the parties and disruptive to the markets to require that the new margin rules apply to those positions. However, the Commission requests comment on whether SDs and MSPs should be permitted voluntarily to include pre-effective date swaps in portfolios margined pursuant to the proposed rules. The Commission also anticipates that existing positions would be taken into account under the capital rule to be proposed at a later date.

The Commission also wishes to emphasize that the proposal does not apply to forward contracts. Under the CEA, the CFTC does not regulate forward contracts. Accordingly, the Commission believes that the requirements of Section 4s(e) do not apply to forward contracts.

### C. Market Participants

#### 1. Overview

The proposed regulations would impose requirements on SDs and MSPs for which there is no prudential regulator (“covered swap entities” or “CSEs”). Because different types of counterparties may pose different levels of risk, the requirements would vary in some respects depending on the category of counterparty. The proposed regulations would not impose margin requirements on non-financial end users.

Proposed § 23.151 would require each CSE to execute documentation regarding credit support arrangements that is consistent with the requirements of these rules with each counterparty. The documentation would specify in advance material terms such as how margin would be calculated, what types of assets would be permitted to be posted, what margin thresholds, if any, would apply, and where margin would be held. This provision is consistent with the documentation requirement recently proposed by the Commission as § 23.504.<sup>6</sup> Having comprehensive documentation in advance concerning these matters would allow each party to a swap to manage its risks more effectively throughout the life of the swap and to avoid disputes regarding issues such as valuation. The Commission solicits comment regarding whether it should require SDs and MSPs to document the procedures by which any disputes concerning the valuation of a swap or the valuation of assets

collected or posted as initial or variation margin may be resolved.

Under rules being proposed by the prudential regulators for SDs and MSPs that are banks, the parties are allowed to make particular variation margin calculations pursuant to a qualifying master netting agreement. The Commission understands that this term will be defined under rules proposed by the prudential regulators to mean a legally enforceable agreement to offset positive and negative mark-to-market values of one or more swaps or security-based swaps that meet a number of specific criteria designed to ensure that these offset rights are fully enforceable, documented, and monitored by the covered swap entity.

As noted, the Commission has previously proposed § 23.504, which requires SDs and MSPs to have swap trading relationship documentation with each counterparty. Under proposed § 23.504(b)(1), this documentation “shall be in writing and shall include all terms governing the trading relationship between the swap dealer or major swap participant and its counterparty, including, without limitation, terms addressing payment obligations, netting of payments, events of default or other termination events, calculation and netting of obligations upon termination, transfer of rights and obligations, governing law, valuation, and dispute resolution procedures.”<sup>7</sup>

Under proposed § 23.600(c)(4)(v)(A), SDs and MSPs would be required to have risk management policies and procedures addressing legal risks associated with their business as swap dealers or major swap participants, including risks associated with “determinations that transactions and netting arrangements entered into have a sound legal basis.”<sup>8</sup> Taken together, it is the Commission’s belief that all SDs and MSPs entering into trading relationship documentation with their counterparties would be required to have a sound legal basis to determine that such agreements will be enforceable in accordance with their terms.

The Commission solicits comment regarding whether proposed §§ 23.501 and 23.600 are sufficient to ensure that SDs and MSPs have a sound legal basis for their swap documentation or whether the Commission should adopt the concept of “qualifying master netting agreements” from existing banking regulations.

<sup>7</sup> *Id.*

<sup>8</sup> See Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants, 75 FR 71397, 71405 (Nov. 23, 2010).

<sup>5</sup> The Commission anticipates that the prudential regulators will publicly post their proposed rules on their Web sites, *see, e.g.*, <http://www.fdic.gov/>.

<sup>6</sup> Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, 76 FR 6715 (Feb. 8, 2011).

## 2. Positions Between CSEs and Other SDs or MSPs

Proposed § 23.152 addresses initial margin and variation margin requirements for positions of CSEs with other SDs or MSPs. (The latter would include both SD/MSPs that are CSEs and SD/MSPs for which there is a prudential regulator.) The regulation would require CSEs to collect initial margin for every uncleared swap with another SD or MSP on or before the date of execution of the swap.<sup>9</sup> The proposed rule would require the CSEs to maintain initial margin from its counterparty equal to or greater than an amount calculated pursuant to proposed § 23.155, discussed below, until the swap is liquidated.<sup>10</sup> The credit support arrangements between a CSE and its counterparty would be prohibited from containing a threshold below which the CSE was not required to post initial margin, *i.e.*, zero thresholds would be required.

(In order to reduce transaction costs, proposed § 23.150 would establish a “minimum transfer amount” of \$100,000. Initial and variation margin payments would not be required to be made if below that amount. This amount was selected in consultation with the prudential regulators. It represents an amount sufficiently small that the level of risk reduction might not be worth the transaction costs of moving the money. It only affects the timing of collection; it does not change the amount of margin that must be collected once the \$100,000 level is exceeded.)

CSEs also would be required to collect variation margin for all trades with another SD or MSP. Again, zero thresholds would be required, and the obligation would continue on each business day until the swap is liquidated. The proposal contains a provision stating that a CSE would not be deemed to have violated its obligation to collect variation margin if

it took certain steps. Specifically, if a counterparty failed to pay the required variation margin to the CSE, the CSE would be required to make the necessary efforts to attempt to collect the variation margin, including the timely initiation and continued pursuit of formal dispute resolution mechanisms, or otherwise demonstrate upon request to the satisfaction of the Commission that it has made appropriate efforts to collect the required variation margin or commenced termination of the swap.

It is the nature of the dealer business that dealers are at the center of the markets in which they participate. Similarly, a major swap participant, by its terms, is a significant trader. Collectively, SDs and MSPs pose greater risk to the markets and the financial system than other swap market participants. Accordingly, under the mandate of Section 4s(e), the Commission believes that they should be required to collect margin from one another.

## 3. Positions Between CSEs and Financial Entities

Proposed § 23.153 addresses initial margin and variation margin requirements for positions between CSEs and financial entities. Proposed § 23.150 would define a financial entity as a counterparty that is not an SD or MSP and that is either: (i) A commodity pool as defined in Section 1a(5) of the Act; (ii) a private fund as defined in Section 202(a) of the Investment Advisors Act of 1940; (iii) an employee benefit plan as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income and Security Act of 1974; (iv) a person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature as defined in Section 4(k) of the Bank Holding Company Act of 1956; (v) a person that would be a financial entity described in (i) or (ii) if it were organized under the laws of the United States or any State thereof; (vi) the government of any foreign country or a political subdivision, agency, or instrumentality thereof; or (vii) any other person the Commission may designate. With three modifications discussed below, this definition tracks the definition in Section 2(h)(7)(C) of the Act that is used in connection with an exception from any applicable clearing mandate.

Item (v) of the proposed definition adds entities that would be a commodity pool or private fund if organized in the United States. The Commission believes that such entities would pose similar risks to those of

similar entities located within the United States.

Item (vi) of the proposed definition adds any government of any foreign country or any political subdivision, agency, or instrumentality thereof. The Commission notes that these types of sovereign counterparties do not fit easily into the proposed rule's categories of financial and nonfinancial entities. In comparing the characteristics of sovereign counterparties with those of financial and nonfinancial entities, the Commission preliminarily believes that the financial condition of a sovereign will tend to be closely linked with the financial condition of its domestic banking system, through common effects of the business cycle on both government finances and bank losses, as well as through the safety net that many sovereigns provide to banks. Such a tight link with the health of its domestic banking system, and by extension with the broader global financial system, makes a sovereign counterparty similar to a financial entity both in the nature of the systemic risk and the risk to the safety and soundness of the covered swap entity. As a result, the Commission preliminarily believes that sovereign counterparties should be treated as financial entities for purposes of the proposed rule's margin requirements.

Item (vii) in the proposed definition permits the Commission to designate additional entities as financial entities. The Commission understands that the prudential regulators are proposing the same provision. This would enable regulators to accomplish the purposes of Section 4s in circumstances where they identify additional entities whose activities and risk profile warrant inclusion. The Commission solicits comment on whether these entities are appropriate, whether additional entities should be designated as financial entities, and what criteria should be applicable.

The Commission believes that financial entities, which generally are not using swaps to hedge or mitigate commercial risk, potentially pose greater risk to CSEs than non-financial entities. Accordingly, if a CSE chooses to expose itself to such risk, it should take steps to mitigate such risks.

Initial margin would be required to be collected by CSEs for every trade with a financial entity on or before the date of execution of the swap. The proposed rule would require the CSEs to maintain initial margin from its counterparty equal to or greater than an amount calculated pursuant to proposed § 23.155, discussed below, until the swap is liquidated.

<sup>9</sup> In previously proposed rules, execution has been defined to mean, “with respect to a swap transaction, an agreement by the counterparties (whether orally, in writing, electronically, or otherwise) to the terms of the swap transaction that legally binds the counterparties to such terms under applicable law.” Confirmation, Portfolio Reconciliation, and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants, 75 FR 81519, 81530 (Dec. 28, 2010). Additionally, swap transaction has been defined to mean “any event that results in a new swap or in a change to the terms of a swap, including execution, termination, assignment, novation, exchange, transfer, amendment, conveyance, or extinguishing of rights or obligations of a swap.” *Id.* at 81531.

<sup>10</sup> The use of the term “liquidated” in this context should be construed to include all ownership events related to that swap, including expiration or maturation.

Zero thresholds would be required except for certain financial entities<sup>11</sup> that: (i) Are subject to capital requirements established by a prudential regulator or a State insurance regulator; (ii) predominantly use swaps to hedge; and (iii) do not have significant swaps exposure.<sup>12</sup> The proposal set forth ranges within which the threshold would fall. These eligibility standards and ranges were established in consultation with the prudential regulators.

The Commission solicits comment on whether thresholds should be permitted at all, and if so, what entities should be eligible, and at what level they should be set. If the Commission determines to permit thresholds, it anticipates that the final rule would establish a single level rather than a range.

Similarly, variation margin would also be required to be collected by CSEs on all transactions with a financial entity. Zero thresholds would be required with the same exception discussed above for initial margin. Any applicable thresholds for initial and variation margin would be separate and therefore could be cumulative. The obligation would continue on each business day until the swap is liquidated.

The Commission notes that under the proposed rule each CSE would be required to collect variation margin from financial entities but would not be required to pay variation margin to them. This approach is consistent with what the prudential regulators are proposing in their margin rules. The rationale is that when an SD pays variation margin to an financial entity that is not subject to capital requirements, money is flowing from a regulated entity to an unregulated one. By following this approach in its proposed rules, the Commission is endeavoring to follow Section 4s(e)(D)(ii)'s requirement that Commission regulations on margin be comparable to those of the prudential regulators "to the maximum extent practicable."

The Commission wishes to highlight and solicits comment regarding the risk management effects of this approach and its appropriateness under Section 4s(e)(E)(3)(A) of the CEA. As noted

above, two-way variation margin has been a keystone of the ability of DCOs to manage risk. Each day current exposure is removed from the market through the payment and collection of variation margin for all products and all participants regardless of their identity or financial resources.

If two-way variation margin were not required for uncleared swaps between CSEs and financial entities, the CSE's exposures may be allowed to accumulate. In contrast to initial margin, which is designed to cover potential future exposures, variation margin addresses actual current exposures, that is, losses that have already occurred. Unchecked accumulation of such exposures was one of the characteristics of the financial crisis which, in turn, led to the enactment of the Dodd-Frank Act.

Moreover, both payment and collection of variation margin help ensure the safety and soundness of the swap dealer or major swap participant. Daily collection helps the safety and soundness of the CSE by removing current exposure from each counterparty. But daily payment also helps safety and soundness by preventing the CSE from building up exposures that it cannot fulfill.

Finally, two-way variation would address the risk associated with the non-cleared swaps held as a swap dealer or major swap participant. Uncleared swaps are likely to be more customized and consequently trade in a less liquid market than cleared swaps. As a result, uncleared swaps might take a longer time and require a greater price premium to be liquidated than cleared swaps, particularly in a distressed market conditions. Failure to remove current exposures in advance of such a situation through daily, two-way variation margin could exacerbate any losses in the event of a SD or MSP default.

Accordingly, in addition to requesting comment on the proposed requirement for collection of variation margin set forth below as 23.153(b)(1), the Commission also requests comment on whether it should adopt an additional provision as follows:

For each uncleared swap between a covered swap entity and a financial entity, each covered swap entity shall pay variation margin as calculated pursuant to § 23.156 of this part directly to the financial entity or to a custodian selected pursuant to § 23.158 of this part. Such payments shall start on the business day after the swap is executed and continue each business day until the swap is liquidated.

Many of the considerations discussed above also might apply to two-way

initial margin. The Commission solicits comments on whether two-way initial margin is appropriate for transactions between CSEs and financial entities.

#### 4. Positions Between CSEs and Non-financial Entities

The proposal would not impose margin requirements on non-financial entities. Proposed § 23.150 would define a non-financial entity as a counterparty that is not a swap dealer, a major swap participant, or a financial entity. The Commission believes that such entities, which are using swaps to hedge commercial risk, pose less risk to CSEs than financial entities. Consistent with Congressional intent,<sup>13</sup> the proposal would not impose margin requirements on such positions.

The proposal would require that CSEs have credit support arrangements in place consistent with proposed § 23.504.<sup>14</sup> This would "help ensure the safety and soundness of the swap dealer or major swap participant" by providing clarity as its rights and obligations. The proposal would not dictate the terms of any margin arrangements other than stating that each covered swap entity may accept as margin from non-financial entities only assets for which the value is reasonably ascertainable on a periodic basis in a manner agreed to by the parties in the credit support arrangements.

The parties would be free to set initial margin and variation margin requirements in their discretion and any thresholds agreed upon by the parties would be permitted. The proposal would require that CSEs pay and collect initial margin and variation margin as set forth in their agreements with their counterparties. The Commission understands that the proposal differs

<sup>13</sup> Letter from Chairman Debbie Stabenow, Committee on Agriculture, Nutrition and Forestry, U.S. Senate, Chairman Frank D. Lucas, Committee on Agriculture, United States House of Representatives, Chairman Tim Johnson, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, and Chairman Spencer Bachus, Committee on Financial Services, United States House of Representatives to Secretary Timothy Geithner, Department of Treasury, Chairman Gary Gensler, U.S. Commodity Futures Trading Commission, Chairman Ben Bernanke, Federal Reserve Board, and Chairman Mary Shapiro, U.S. Securities and Exchange Commission (April 6, 2011); Letter from Chairman Christopher Dodd, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, and Chairman Blanche Lincoln, Committee on Agriculture, Nutrition, and Forestry, U.S. Senate, to Chairman Barney Frank, Financial Services Committee, United States House of Representatives, and Chairman Collin Peterson, Committee on Agriculture, United States House of Representatives (June 30, 2010); see also 156 Cong. Rec. S5904 (daily ed. July 15, 2010) (statement of Sen. Lincoln).

<sup>14</sup> Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, 76 FR 6715 (Feb. 8, 2011).

<sup>11</sup> The prudential regulators proposed rulemaking refers to these financial entities as "low-risk" financial entities based on the relative risk posed by the type of counterparty.

<sup>12</sup> Significant swap exposure is defined by reference to rules previously proposed by the Commission. See Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant" 75 FR 80174 (Dec. 21, 2010).

from the proposal of the prudential regulators which would require that CSEs collect variation margin from non-financial entities at least once per week, if applicable thresholds were exceeded.

The proposal would require each CSE to calculate hypothetical initial and variation margin amounts each day for positions held by non-financial entities. That is, the CSE must calculate what the margin amounts would be if the counterparty were another SD or MSP.<sup>15</sup> These calculations would serve as risk management tools that would assist the CSE in measuring its exposure. Moreover, they would likely be necessary for CSEs in computing any capital requirements that might be applicable.

#### *D. Calculation of Initial Margin*

Proposed § 23.155 addresses how initial margin should be calculated. Models meeting specified standards would be permissible. If no model meeting the standards of the rule is available, the CSE would set margin in accordance with an alternative approach described below.

##### **1. Models**

Proposed § 23.155(b) sets forth requirements for models. Under proposed § 23.155(b)(1), the following would be eligible: (i) A model currently in use for margining cleared swaps by a DCO, (ii) a model currently in use for margining uncleared swaps by an entity subject to regular assessment by a prudential regulator, or (iii) a model available for licensing to any market participant by a vendor. Unlike the banking institutions that will be overseen by the prudential regulators, the CSEs subject to the Commission's regulations may not have proprietary models. Moreover, given current budget constraints, the Commission does not have the resources to review numerous models individually. Accordingly, at this time, the Commission is proposing to permit the use of certain non-proprietary models. The proposal, however, also contains a provision which would permit the Commission to issue an order that would allow the use of proprietary models in the future should the Commission obtain sufficient resources.

This is an aspect of the proposal that differs from the prudential regulators' approach. Because many banks already have proprietary models, and because the prudential regulators have the resources to review individual

proprietary models, the prudential regulators would not permit the use of DCO models or the use of models licensed to market participants. The Commission solicits comment on the feasibility of the use of DCO models or third party models by CSEs for margining uncleared swaps.

Proposed § 23.155(b)(2) further requires that a model meet specified standards. The following are some of the elements that would be required in a model:

- The valuation of a swap must take into account all significant, identifiable risk factors, including any non-linear risk characteristics;
  - The valuation of a swap must be based on pricing sources that are accurate and reliable;
  - The model must set margin to cover at least 99% of price changes by product and by portfolio over at least a 10-day liquidation horizon;
  - The model must be validated by an independent third party before being used and annually thereafter;
  - The swap dealer or major swap participant must conduct back testing and stress testing of the model on a regular basis; and
  - If the swap product is also offered for non-mandatory clearing by a registered DCO, the initial margin collected may not be less than the initial margin required by the DCO.
- Parties could add individualized credit surcharges to the margin amount produced by the model.

These standards are consistent with the standards that the Commission understands that the prudential regulators are proposing. They are also similar to the standards the Commission has used in evaluating DCO margin models, and that prudential regulators have used in assessing bank margin models.

Proposed § 23.155(b)(3) would require that models be filed with the Commission. The filing would include a complete explanation of:

- The manner in which the model meets the requirements of this section;
- The mechanics of the model;
- The theoretical basis of the model;
- The empirical support for the model; and
- Any independent third party validation of the model.

Under proposed § 23.155(b)(4), the Commission could approve or deny the application by an SD or MSP to use an initial margin model, or approve an amendment to the application, in whole or in part, subject to any conditions or limitations the Commission may require, if the Commission finds the

approval to be necessary or appropriate in the public interest after determining, among other things, whether the applicant had met the requirements of the section and was in compliance with other applicable rules promulgated under the Act and by self-regulatory organizations.

Under proposed § 23.155(b)(4), the Commission also could at any time require a CSE to provide further data or analysis concerning the amount of initial margin required or on deposit. In addition, the Commission could at any time require a CSE to modify the model to address potential vulnerabilities. These measures are designed to be prudent safeguards to be used to address weaknesses that may only become apparent over time.

##### **2. Alternative Method**

Proposed § 23.155(c) provides that if a model meeting the standards of the rule is not used, margin must be calculated in accordance with a specified alternative method. The Commission determined that a potentially effective way to measure the risk of uncleared swaps in cases where models were unavailable would be to base the margin requirements on the margin requirements for related cleared products.

Proposed § 23.155(c)(1) provides that the CSE identify in the credit support arrangements the swap cleared by a DCO in the same asset class as the uncleared swap for which the terms and conditions most closely approximate the terms and conditions of the uncleared swap. If there is no cleared swap whose terms and conditions closely approximate the uncleared swap, the swap dealer or major swap participant must identify in the credit support arrangements the futures contract cleared by a DCO in the same asset class as the uncleared swap which most closely approximates the uncleared swap and would be most likely to be used to hedge the uncleared swap.

The CSE would ascertain the margin the DCO would require for the position. The CSE would then multiply the amount for a cleared swap by 2.0 in order to determine the margin required for the uncleared swap or multiply the amount for a cleared futures contract by 4.4 in order to determine the margin required for the uncleared swap.

The multiplier is calculated by comparing the anticipated liquidation time horizon for the cleared product to the anticipated liquidation time horizon for the uncleared swap and then applying several add-ons for additional risk factors. To illustrate, typically, a cleared futures contract is margined

<sup>15</sup> This is consistent with the requirement set forth in Section 4s(h)(3)(B)(iii)(II) that SDs and MSPs must disclose to counterparties who are not SDs or MSPs a daily mark for uncleared swaps.

using a one-day liquidation time period, while under the proposal, an uncleared swap would be margined using a 10-day period. A standard way to measure the increase in risk over the longer period is to multiply the margin for the shorter period by the square root of the longer period. The square root of 10 is 3.162.

The proposal would increase this number to address several additional risks. A 10% cushion would be added to reflect that a 10-day period may be insufficient for some customized products. An additional 10% cushion would be added to reflect that the square root method assumes a normal distribution of prices which might not be true for customized products. An additional 20% cushion would be added to reflect the basis risk between the cleared and uncleared products. Taking into account these add-ons yields a total multiplier of 4.4.

A similar calculation for cleared swaps yields a multiplier of 2.0. The margin for cleared swaps generally would be higher than the margin for cleared futures because cleared swaps generally would be subject to a 5-day liquidation time.<sup>16</sup> The greater similarity in the anticipated liquidation time results in a smaller multiplier when comparing uncleared swaps to cleared swaps than when comparing uncleared swaps to cleared futures.

This alternative model is another aspect of the proposal that differs from the prudential regulators' approach. Their alternative uses percentages of notional value. The Commission considered using a similar approach but recognized that the use of notional percentages is an imprecise measure that does not capture the nuances of risk and it appeared to be more appropriate to base initial margins for uncleared swaps on those required by DCOs for similar cleared swaps. The Commission invites comment on the relative merits of the two alternative approaches. In this regard, the Commission requests comment on the appropriateness of the levels of initial margin set forth in the prudential regulators' alternative approach.

Proposed § 23.155(c)(2) addresses portfolio offsets for swaps with correlated risk profiles under the

alternative method. Again, the proposal is conservative. Reductions in margin based on offsetting risk characteristics of products would not be permitted across asset classes except between currencies and interest rates. Any reductions in margin based on offsetting risk characteristics of products within an asset class must have a sound theoretical basis and significant empirical support. No reduction may exceed 50% of the amount that would be required for the swap in the absence of a reduction.

Proposed § 23.155(c)(3) provides for modifications for particular products or positions. Each CSE would be required to monitor the coverage provided by margin established pursuant to this paragraph (c) and collect additional margin if appropriate to address the risk posed by particular products or positions.

Under proposed § 23.155(c)(4), the Commission could at any time require the CSE to post or collect additional margin because of additional risk posed by a particular product. Furthermore, the Commission could at any time require a CSE to post or collect additional margin because of additional risk posed by a particular party to the swap. For example, if the Commission were to learn that a particular counterparty was experiencing financial difficulty, it might need to take steps to ensure that the CSE held margin appropriate for the risk associated with the position. These measures are designed to be prudent safeguards similar to those discussed above.

#### *E. Calculation of Variation Margin*

Proposed § 23.156 addresses how variation margin should be calculated. Proposed § 23.156(b) sets forth several requirements. The valuation of each swap must be determined pursuant to a method agreed upon by the parties in the credit support arrangements. It must be consistent with the requirements set forth in proposed Section 23.504(b) of this part.<sup>17</sup> It must be set forth with sufficient specificity to allow the counterparty, the Commission, and any applicable prudential regulator to calculate the requirement independently.

Under proposed § 23.155(c), the Commission could at any time require the CSE to provide further data or analysis concerning the methodology. Furthermore, the Commission could at any time require a CSE to modify the methodology to address potential

vulnerabilities. These measures are designed to be prudent safeguards to be used to address weaknesses that may only become apparent over time.

As noted above, the Commission previously proposed § 23.504(b)(4), which would require that the swap trading documentation include written documentation in which the parties agree on the methods, procedures, rules and inputs for determining the value of each swap at any time from execution to the termination, maturity, or expiration of the swap. The agreed methods, procedures, rules and inputs would be required to constitute a complete and independently verifiable methodology for valuing each swap entered into between the parties. Proposed § 23.504(b)(4)(iii) would require that the methodology include complete alternative methods for determining the value of the swap in the event that one or more inputs to the methodology become unavailable or fail, such as during times of market stress or illiquidity. The provisions proposed in this release are intended together with those previously proposed rules to ensure that all swap positions are accurately and reliably marked to market and all valuation disputes are resolved in a timely manner, thereby reducing risk.

#### *F. Forms of Margin*

Proposed § 23.157 addresses the types of assets that would be acceptable as margin in transactions involving CSEs. There are differences between initial margin and variation margin and within each category depending on counterparties.

##### *1. Initial Margin*

Proposed § 23.157(a)(2) provides that CSEs may only accept as initial margin from SDs, MSPs, or financial entities, the following assets:

- Immediately available cash funds denominated in U.S. dollars or the currency in which payment obligations under the swap are required to be settled;
- Any obligation which is a direct obligation of, or fully guaranteed as to principal and interest by, the United States or an agency of the United States; or
- Any senior debt obligation of the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation, or any obligation that is an "insured obligation," as that term is defined in 12 U.S.C. 2277a(3), of a Farm Credit System bank.

<sup>16</sup> In rules the Commission previously proposed for DCOs, cleared swaps traded on a swap execution facility or executed bilaterally would be subject to a minimum five-day liquidation period for purposes of calculating initial margin, whereas swaps traded on a designated contract market may be subject to a minimum one-day requirement. Risk Management Requirements for Derivatives Clearing Organizations, 76 FR 3698, 3704–05 (Jan. 20, 2011). To the extent that a cleared swap was subject to the one-day requirement, the appropriate multiplier would be the same as the futures multiplier.

<sup>17</sup> Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, 76 FR 6715 (Feb. 8, 2011).

These are assets for which there are deep and liquid markets and, therefore, assets that can be readily valued and easily liquidated. The Commission requests comment on whether additional types of assets should be acceptable.

To the extent a non-financial entity and a CSE have agreed that the non-financial entity will post initial margin, proposed § 23.157(a)(3) provides flexibility for initial margin posted by non-financial entities with CSEs as to what assets are permissible. The standard is simply that the value of the asset is reasonably ascertainable on a periodic basis. This is in accordance with the statement in Section 4s(e)(3)(C) that the Commission permit the use of non-cash collateral as it determines consistent with preserving the financial integrity of the markets and preserving the stability of the United States

financial system. The Commission understands that current market practice would support a periodic valuation of the assets used as noncash collateral, but solicits comment from market participants regarding how practical the requirement is. In particular, the Commission requests comment on how frequently such collateral could and should be valued.

The Commission understands that this differs from the proposal of the prudential regulators. The prudential regulators would require CSEs to collect as initial margin for non-financial entities only the assets listed previously to cover any exposure above the credit exposure limit.

## 2. Variation Margin

Proposed § 23.157(b) would require that variation payments by CSEs, or financial entities be in cash or United

States Treasury securities. This is consistent with the general purpose of variation margin of eliminating current exposure through the use of liquid, easily valued assets.

To the extent a non-financial entity and a CSE have agreed that the non-financial entity will post variation margin, proposed § 23.157(b)(3) provides flexibility for variation margin posted by non-financial entities with CSEs as to what assets are permissible. The standard is simply that the value of the asset is reasonably ascertainable on a periodic basis. As was the case for initial margin, this is in accordance with the statement in Section 4s(e)(3)(C) that the Commission permit the use of non-cash collateral.

Proposed § 23.157(c) establishes haircuts for assets received by a CSE from an SD, MSP, or financial entity as follows:

### MARGIN VALUE RANGES FOR NON-CASH COLLATERAL

[% of market value]

	Duration (years)		
	0–5	5–10	> 10
U.S. Treasuries and Fully Guaranteed Agencies:			
Bills/Notes/Bonds/Inflation Indexed .....	[98–100]	[95–99]	[94–98]
Zero Coupon, STRIPs .....	[97–99]	[94–98]	[90–94]
FHFA–Regulated Institutions Obligations and Insured Obligations of FCS Banks:			
Bills/Notes/Bonds .....	[96–100]	[94–98]	[93–97]
Zero Coupon .....	[95–99]	[93–97]	[89–93]

These haircuts were based on a consultation with prudential regulators who use them in other contexts.

Proposed § 23.157(d) would authorize certain actions by the Commission regarding margin assets. The Commission could:

- Require a CSE to provide further data or analysis concerning any margin asset posted or received;
- Require a CSE to replace a margin asset posted to a counterparty with a different margin asset to address potential risks posed by the asset;
- Require a CSE to require a counterparty that is an SD, MSP, or a financial entity to replace a margin asset posted with the CSE with a different margin asset to address potential risks posed by the asset;
- Require a CSE to provide further data or analysis concerning margin haircuts; or
- Require a CSE to modify a margin haircut applied to an asset received from an SD or MSP, or a financial entity to address potential risks posed by the asset.

All these actions are intended to be methods for ensuring the safety and

soundness of the CSE and protecting the financial system.

## G. Custodial Arrangements

Proposed § 23.158 addresses custodial arrangements. The proposal is intended to safeguard margin assets.

Under proposed § 23.158(a) each CSE must offer each counterparty the opportunity to select a custodian that is not affiliated with the CSE. Further, each CSE must hold initial margin received from a counterparty that is an SD or MSP at a custodian that is independent of the CSE and the counterparty. Similarly, a CSE that posts initial margin with a counterparty that is an SD or MSP must require the counterparty to hold the initial margin at a custodian that is independent of the SD or MSP and the counterparty.

Further, the proposal would require that the custodian be subject to the same insolvency regime as the CSE. This would facilitate quicker recovery of margin assets.

Under proposed § 23.158(b)(1) each CSE must specify in each custodial agreement that the custodian may not rehypothecate margin assets or reinvest

them in assets that are not permitted forms of margin. Further, upon certification to the custodian in accordance with the provisions of 23.602(b)(1) by a party that it is entitled to receipt of margin, the custodian must release margin to the certifying party.<sup>18</sup> Under proposed § 23.158(b)(2), upon receipt of initial margin from a counterparty, no CSE may post such assets as margin for a swap, a security-based swap, a commodity for future delivery, a security, a security futures product, or any other product subject to margin. These provisions are designed to prevent the same asset from being passed around as margin for multiple positions.

Under proposed § 23.158(c), the Commission may at any time require a CSE to provide further data or analysis concerning any custodian. Further, the Commission may at any time require a CSE participant to move assets held on behalf of a counterparty to another custodian to address risks posed by the

<sup>18</sup> Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy, 75 FR 75432 (Dec. 3, 2010).

original custodian. These provisions are designed to protect the assets of the parties to the contract.

#### *H. Request for Comment*

The Commission requests comment on all aspects of the proposed rules regarding margin. In particular, the Commission requests comment on the following:

- Are proposed §§ 23.501 and 23.600 sufficient to ensure that SDs and MSPs have a sound legal basis for their swap documentation, or should the Commission adopt the concept of “qualifying master netting agreements” from existing banking regulations?
- It is the Commission’s understanding that the prudential regulators would require SDs and MSPs that are banks to appropriately take into account and address the credit risk posed by the counterparty and the risks of uncleared swaps, and further the prudential authorities would require SDs and MSPs that are banks to enforce those credit limit policies, or credit thresholds, with regard to the banks’ counterparties. The Commission previously proposed § 23.600(c)(1),<sup>19</sup> which would require SDs and MSPs to set risk tolerance limits for themselves. One of the critical risk limits in any risk management program would relate to credit risk. The Commission solicits comment regarding whether it should adopt a requirement, similar to the one proposed by the prudential authorities, requiring non-bank SDs and MSPs to enforce their credit risk limits as a matter of policy.
- What effects will the proposed rules have on the overall liquidity of the financial markets?
- Would the proposed rules have differing effects on liquidity by asset class?
- Would the proposed rules have differing effects on liquidity by class of participant?
- Should the Commission permit thresholds for either initial margin or variation margin?
- If so, what standards should apply?
- Is the proposed definition of financial entity appropriate?

<sup>19</sup> See Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants, 75 FR 71397, 71404 (Nov. 23, 2010) (requiring that SDs and MSPs “take into account market, credit, liquidity, foreign currency, legal, operational, settlement, and any other applicable risks together with a description of the risk tolerance limits set by the swap dealer or major swap participant and the underlying methodology”). Additionally, the risk tolerance limits would have to be reviewed and approved quarterly by senior management and annually by the governing body, and exceptions to risk tolerance limits would require prior approval of a supervisor in the risk management unit.

- Should the Commission instead define financial entity as a person that is not eligible to claim an exception from mandatory clearing under section 2(h)(7) of the Act?
- Should the Commission exercise authority to designate additional persons as financial entities?
- If so, what standards should apply?
- Do the definitions adequately identify financial entities that have different levels of risk?
- Should nonfinancial entities also be separated according to levels of risk?
- If so, on what basis (e.g., in a manner similar to the classification of financial entities)?
- If so, how should the requirement apply differently to such nonfinancial entities?
- Is the classification of sovereign counterparties as financial entities appropriate in light of the risks posed by these counterparties?
- If not, what other classification would be appropriate, and why?
- Should sovereign counterparties receive their own distinct counterparty classification that is different from those classifications in the proposed rule?
- If so, why?
- How should the permitted uncollateralized exposures to a sovereign counterparty differ from those that are allowed for financial or non-financial entities?
- Is it appropriate to distinguish between financial and non-financial counterparties for the purpose of this risk-based approach?
- Does the proposed rule require greater clarity with respect to the treatment of U.S. Federal, State, or municipal government counterparties? If so, how should such counterparties be treated?
- Should a counterparty that is a bank holding company or nonbank financial firm subject to enhanced prudential standards under Section 165 of the Dodd-Frank Act be treated similarly to swap entity counterparties?
- Should counterparties that are small financial institutions using derivatives to hedge their risks be treated in the same manner as non-financial entities for purposes of the margin requirements?
- Would requiring a CSE to post initial margin to non-SD/MSP counterparties reduce systemic risk (e.g., by reducing leverage in the financial system or reducing systemic vulnerability to the failure of a covered swap entity)?
- Are there alternatives that address those risks more efficiently or with greater transparency?
- Would requiring a CSE to post initial margin to non-SD/MSP

counterparties raise any concerns with respect to the safety and soundness of the CSE, taking into consideration the requirement that initial margin be segregated and held with a third party custodian?

- Would requiring a CSE to post initial margin to non-SD/MSP counterparties remove one or more incentives for that CSE to choose, where possible, to structure a transaction so that it need not be cleared through a DCO in order to avoid pledging initial margin?
- Would this approach be consistent with the statutory factors the Commission is directed to take into account under sections 4s of the Act?
- Is one-way initial margin in trades between CSEs and financial entities consistent with the requirement under Section 4s(e) that margin requirements offset the greater risk arising from the use of swaps that are not cleared?
- Is one-way variation margin in trades between CSEs and financial entities consistent with the requirement under Section 4s(e) that margin requirements offset the greater risk arising from the use of swaps that are not cleared?
- Is one-way initial margin in trades between CSEs and financial entities consistent with the requirement under Section 4s(e) that margin requirements help ensure the safety and soundness of SDs and MSPs?
- Is one-way variation margin in trades between CSEs and financial entities consistent with the requirement under Section 4s(e) that margin requirements help ensure the safety and soundness of SDs and MSPs?
- Is one-way initial margin in trades between CSEs and financial entities consistent with the requirement under Section 4s(e) that margin requirements be appropriate for the risks associated with uncleared swaps?
- Is one-way variation margin in trades between CSEs and financial entities consistent with the requirement under Section 4s(e) that margin requirements be appropriate for the risks associated with uncleared swaps?
- Is one-way initial margin in trades between CSEs and financial entities consistent with the requirement under section 15(b) that the Commission endeavor to take the least anticompetitive means of achieving the objectives of the Act?
- Is one-way variation margin in trades between CSEs and financial entities consistent with the requirement under section 15(b) that the Commission endeavor to take the least anticompetitive means of achieving the objectives of the Act?

- If initial and variation margin are not required to be paid by CSEs to non-SDs/MSPs, does it create an expectation that a swap dealer subject to oversight by a prudential regulator is more creditworthy than other swap dealers because it might receive a financial backstop?

- What are the bankruptcy implications for counterparties of SDs or MSPs if initial and variation margin are not required to be paid by CSEs to non-SDs/MSPs?

- Is the minimum transfer amount appropriate?

- Are there widely-available initial margin models that could be used?

- Is the adaptation of DCO models for use for uncleared swaps feasible?

- Should models approved by foreign regulators be permitted?

- Should models be limited to models based on value-at-risk concepts, or are other models appropriate to measure initial margin?

- If so, how should those models apply and be incorporated into the various aspects of the proposed rule?

- To the extent that the parties' swap trading relationship documentation would permit portfolio margining of swaps, should SDs and MSPs be permitted to include swaps executed prior to the effective date of these margin rules in their calculation of initial margin, provided that the parties would include all swaps covered by that documentation (*i.e.*, they would not be permitted to selectively include certain swaps in the portfolio)?

- Should offsetting exposures, diversification, and other hedging benefits be recognized more broadly across substantially dissimilar asset classes?

- If so, what limits, if any, would be placed on the recognition of offsetting exposures, diversification, and other hedging benefits, and how could these be measured, monitored and validated on an ongoing and consistent basis across substantially dissimilar asset classes?

- Should the minimum time horizon vary across swaps? For example, should it vary based on asset class?

- If so, how should the horizons differ and what would be the basis for the different horizons?

- Can initial margin models be calibrated to a stress period in a transparent and consistent manner?

- Are there any other systemic risk implications of requiring that initial margin be calibrated to a period of financial stress rather than to a recent or normal historical period?

- Is the proposed prudential standard for initial margin of a 99th percentile

price move over a 10-day horizon, calibrated using historical data incorporating a period of significant financial stress, appropriate?

- Is a 10-day horizon sufficient to cover the likely liquidation period on uncleared swaps?

- Will the requirement to calibrate to a period of significant financial stress reduce the potential procyclicality of the margin requirement sufficiently? For example, would a minimum margin requirement as a backstop to the modeled initial margin amounts be a prudent approach to addressing procyclicality concerns?

- Is "period of significant financial stress" a well-understood concept? How might it be clarified?

- What would be the benefits and costs of replacing the requirement to calibrate the initial margin model using a period of significant financial stress with a requirement to calibrate the initial margin model using a longer historical data sample (such as 10 years), as an alternative way to reduce the potential procyclicality of the margin requirement?

- Should market participants be able to comply with the requirement to calibrate the initial margin requirement to a historical period of significant financial stress for newer products with little, if any, market history?

- If so, how?

- Should CSEs be required to disclose their models to their counterparties who are not SDs or MSPs?

- How closely does the alternative methodology approximate risk?

- Would a percentage of notional value approach be appropriate under any circumstances?

- With respect to either alternative for calculating initial margin requirements, should swap positions that pose no counterparty risk to the covered swap entity, such as a sold call option with the full premium paid at inception of the trade, be excluded from the initial margin calculation?

- Is the list of acceptable forms of margin appropriate?

- Should the types of eligible collateral listed be broadened to other types of assets (*e.g.* securities backed by high-quality mortgages or issues with a third-party guarantee)?

- If so, how might the systemic risk issue be effectively mitigated?

- Should the types of eligible collateral listed be broadened to include immediately-available cash funds denominated in foreign currency, even where such currency is not the currency in which payment obligations under the swap are required to be settled?

- If so, which currencies (*e.g.*, those accepted by a derivatives clearing organization as initial margin for a cleared swap)?

- If so, what haircut, if any, should apply to such foreign currency?

- What criteria and factors could be used to determine the set of acceptable non-cash collateral?

- How could appropriate haircuts be determined for valuing these assets for margin purposes?

- Should the types of eligible collateral listed be broadened to include foreign sovereign debt securities?

- If so, which foreign sovereign debt securities (*e.g.*, those accepted by a derivatives clearing organization as initial margin for a cleared swap)?

- If so, what haircut, if any, should apply?

- Should fixed income securities issued by a well-known seasoned issuer that has a high credit standing, are unsubordinated, historically display low volatility, are traded in highly liquid markets, and have valuations that are readily calculated be added to the list of eligible collateral for initial margin?

- If so, how should the concept of a "high credit standing" be defined in a way that does not reference credit ratings?

- Should there be any limits on the types of collateral accepted by CSEs from non-financial entities?

- The proposal states that each covered swap entity shall accept as margin from non-financial entities only assets for which the value is reasonably ascertainable on a periodic basis in a manner agreed to by the parties in the credit support arrangements. Should the Commission be more specific with regard to how non-traditional collateral should be valued?

- Should the Commission be more specific with regard to how frequently margin assets should be valued?

- Is the table of haircuts appropriate?

- Are the proposed custodial arrangements appropriate?

- Is it necessary to require segregation of initial margin in order to address the systemic risk issues discussed above?

- What alternatives to segregation would effectively address these systemic risk issues?

- What are the potential operational, liquidity and credit costs of requiring segregation of initial margin by swap entities?

- What would be the expected liquidity impact and cost of the proposed segregation requirement on market participants?

- How can the impact of the proposed rule on the liquidity and costs of swaps market participants be mitigated?

- Are the limitations placed on rehypothecation and reinvestment under the proposed rule appropriate or necessary?
- Would additional or alternative limitations be appropriate?
- Should certain forms of rehypothecation (e.g., the lending of securities pledged as collateral) or additional types of reinvestment be permitted?
- Is the proposed rule's requirement that the custodian must be located in a jurisdiction that applies the same insolvency regime to the custodian as would apply to the covered swap entity necessary or appropriate?
- Would additional or alternative requirements regarding the location of the custodian be appropriate?
- Are there circumstances where rehypothecation should be permitted?
- What role could self-regulatory organizations play in overseeing compliance with the proposed regulations?
- In designing these rules, the Commission has taken care to minimize the burden on those parties that will not be registered with the Commission as SDs and MSPs. To the extent that market participants believe that additional measures should be taken to reduce the burden or increase the benefits of documenting swap transactions, the Commission welcomes all comments.
- Pursuant to Section 716, certain "push-out" entities might initially be subject to the margin rules of the prudential regulators, but by July of 2013 would come under the margin rules of the Commission. The Commission requests comment on what steps would be appropriate to facilitate a smooth transition for such entities and their counterparties.
- The Commission recognizes that there will be differences in the size and scope of the business of particular SDs and MSPs. Therefore, comments are solicited on whether certain provisions of the proposed regulations should be modified or adjusted to reflect the differences among SDs and MSPs or differences among asset classes.
- How long would SDs and MSPs require to come into compliance with the proposed rules? Will compliance take less time for swaps between such registrants and longer for swaps between registrants and non-registrants?

### III. Related Matters

#### A. Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA) requires that agencies consider whether the regulations they propose will have

a significant economic impact on a substantial number of small entities.<sup>20</sup> The Commission previously has established certain definitions of "small entities" to be used in evaluating the impact of its regulations on small entities in accordance with the RFA.<sup>21</sup> The proposed regulations would affect SDs and MSPs.

SDs and MSPs are new categories of registrants. Accordingly, the Commission has not previously addressed the question of whether such persons are, in fact, small entities for purposes of the RFA. The Commission previously has determined, however, that futures commission merchants ("FCMs") should not be considered to be small entities for purposes of the RFA.<sup>22</sup> The Commission's determination was based, in part, upon the obligation of FCMs to meet the minimum financial requirements established by the Commission to enhance the protection of customers' segregated funds and protect the financial condition of FCMs generally.<sup>23</sup> Like FCMs, SDs will be subject to minimum capital and margin requirements and are expected to comprise the largest global financial firms. The Commission is required to exempt from SD registration any entities that engage in a de minimis level of swaps dealing in connection with transactions with or on behalf of customers. The Commission believes that this exemption would exclude small entities from registration. Accordingly, for purposes of the RFA for this rulemaking, the Commission is hereby determining that SDs are not "small entities" for essentially the same reasons that FCMs have previously been determined not to be small entities and in light of the exemption from the definition of SD for those engaging in a de minimis level of swap dealing.

The Commission also has previously determined that large traders are not "small entities" for RFA purposes.<sup>24</sup> In that determination, the Commission considered that a large trading position was indicative of the size of the business. MSPs, by statutory definition, maintain substantial positions in swaps or maintain outstanding swap positions that create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets. Accordingly, for purposes of the RFA for this rulemaking, the Commission is hereby

determining that MSPs are not "small entities" for essentially the same reasons that large traders have previously been determined not to be small entities.

The Commission also previously has determined that ECPs are not small entities for RFA purposes. Because ECPs are not small entities, and persons not meeting the definition of ECP may not conduct transactions in uncleared swaps, the Commission need not conduct a regulatory flexibility analysis respecting the effect of these proposed rules on ECPs.

Accordingly, this proposed rule will not have a significant economic effect on any small entity. Therefore, the Chairman, on behalf of the Commission, hereby certifies pursuant to 5 U.S.C. 605(b) that the proposed regulations will not have a significant economic impact on a substantial number of small entities.

#### B. Paperwork Reduction Act

The Paperwork Reduction Act (PRA)<sup>25</sup> imposes certain requirements on Federal agencies (including the Commission) in connection with their conducting or sponsoring any collection of information as defined by the PRA. This proposed rulemaking would result in the collection of information requirements within the meaning of the PRA, as discussed below. The collections of information that are proposed by this rulemaking are found in proposed § 23.151 and § 23.155 and are necessary to implement new Section 4s(e) of the CEA, which expressly requires the Commission to adopt rules governing margin requirements for SDs and MSPs. For the sake of operational efficiency, the Commission will be submitting a consolidated PRA proposal for both the capital and margin rules to the Office of Management and Budget (OMB) for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11.

*Collection of Information.* (Regulations and Forms Pertaining to the Financial Integrity of the Marketplace, OMB Control Number 3038-0024.)

#### C. Cost-Benefit Analysis

Section 15(a) of the CEA<sup>26</sup> requires the Commission to consider the costs and benefits of its actions before issuing a rulemaking under the CEA. Section 15(a) specifies that the costs and benefits shall be evaluated in light of five broad areas of market and public concern: (1) Protection of market participants and the public; (2) efficiency, competitiveness, and

<sup>20</sup> 5 U.S.C. 601 *et seq.*

<sup>21</sup> 47 FR 18618 (Apr. 30, 1982).

<sup>22</sup> *Id.* at 18619.

<sup>23</sup> *Id.*

<sup>24</sup> *Id.* at 18620.

<sup>25</sup> 44 U.S.C. 3501 *et seq.*

<sup>26</sup> 7 U.S.C. 19(a).

financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations. The Commission may in its discretion give greater weight to any one of the five enumerated areas and could in its discretion determine that, notwithstanding its costs, a particular regulation is necessary or appropriate to protect the public interest or to effectuate any of the provisions or to accomplish any of the purposes of the CEA.

**Summary of proposed requirements.** The proposed regulations would implement certain provisions of section 731 of the Dodd-Frank Act, which adds new sections 4s(e) of the CEA. Under the proposal, each CSE would be required to execute swap trading relationship documentation regarding credit support arrangements with each swap counterparty, including other SDs or MSPs. The proposed regulations also would require each CSE to calculate and to collect from its counterparties, that are SDs, MSPs, or financial entities, initial margin for each bilateral swap transaction that was not cleared by or through a derivatives clearing organization. The proposal also would require each CSE to calculate each business day, and collect from its counterparties, that are SDs, MSPs, or financial entities, variation margin for each bilateral swap transaction that is not cleared by or through a derivatives clearing organization. CSEs, however, are not required to collect initial margin or exchange variation margin with a counterparty that qualifies as a non-financial entity.

**Costs.** The Commission recognizes that to the extent SDs and MSPs currently do not post initial margin with one another, and have thresholds for variation margin, the proposal will impose costs upon them. The Commission further recognizes that to the extent that financial entities currently do not post initial margin or have high variation margin thresholds, the proposal will impose costs upon them.

The Commission notes that while the amounts of initial margin that would be required to be posted would be substantial, initial margin is a performance bond. Thus, the cost is not equal to the total initial margin posted, but rather the opportunity cost of immobilizing those assets. That is, SDs, MSPs, and financial entities would likely receive a lower return on the resources posted as margin than they would receive if they were free to apply those resources to other uses.

With respect to variation margin, sound risk management dictates that counterparties mark open positions to the market. Therefore, the costs here would also be opportunity costs. That is, to the extent SDs, MSPs, and financial entities currently have variation margin thresholds, they might be required to pay variation margin more frequently or earlier than would occur in the absence of the rule.

The Commission does not believe that the requirement that the parties document their credit support arrangements will impose significant costs. The Commission understands that such documentation is widespread if not universal.

**Benefits.** The Commission believes that the benefits of the proposal are very significant. The economy recently experienced a severe recession. A key contributing factor was the problems suffered by large institutions in the financial services sector. Those problems were, in part, attributable to positions those firms held in swaps.

Many of those firms are likely to be SDs, MSPs, or financial entities. As discussed more fully above, the Commission believes that the proposed margin requirements will significantly decrease the risk that SDs, MSPs, and financial entities will incur such extreme losses on their swap positions as to imperil the financial system of the United States. In addition to this systemic benefit, the proposal would benefit each of the individual participants in the swaps market by increasing the security of their positions as well as the financial integrity of their counterparties. In this regard, the Commission notes that the requirements proposed here are substantially the same as the requirements that the prudential regulators are proposing.

In sum, the Commission believes that the benefits to the overall financial system, and to the individual participants in the swaps market, outweigh the costs to those participants.

**Public Comment.** The Commission invites public comment on its cost-benefit considerations. Commentators are also invited to submit any data or other information that they may have quantifying or qualifying the costs and benefits of the Proposal with their comment letters.

#### List of Subjects in 17 CFR Part 23

Swaps, Swap dealers, Major swap participants, Capital and margin requirements.

For the reasons stated in this release, the Commission proposes to amend 17 CFR part 23, as proposed to be added at

75 FR 71379, published November 23, 2010, as follows:

#### PART 23—SWAP DEALERS AND MAJOR SWAP PARTICIPANTS

1. The authority citation for part 23 to read as follows:

**Authority:** 7 U.S.C. 1a, 2, 6, 6a, 6b–1, 6c, 6p, 6r, 6s, 6t, 9, 9a, 12, 12a, 13b, 13c, 16a, 18, 19, 21.

2. Subpart E is added to read as follows:

##### Subpart E—Capital and Margin Requirements for Swap Dealers and Major Swap Participants

Sec.

23.100–23.149 [Reserved]

23.150 Definitions applicable to margin requirements.

23.151 Documentation of credit support arrangements.

23.152 Margin treatment for uncleared swaps between covered swap entities and swap dealers and major swap participants.

23.153 Margin treatment for uncleared swaps between covered swap entities and financial entities.

23.154 Margin treatment for uncleared swaps between covered swap entities and non-financial entities.

23.155 Calculation of initial margin.

23.156 Calculation of variation margin.

23.157 Forms of margin.

23.158 Custodial arrangements.

##### Subpart E—Capital and Margin Requirements for Swap Dealers and Major Swap Participants

#### §§ 23.100 through 23.149 [Reserved]

#### § 23.150 Definitions applicable to margin requirements.

For the purposes of §§ 23.150 through 23.158 of this part:

**Asset class** means a group of products that are based on similar types of underlying assets. Swaps shall be grouped within the following asset classes: agricultural, credit, currency, energy, equity, interest rate, metals, and other.

**Back test** means a test that compares initial margin requirements with historical price changes to determine the extent of actual margin coverage.

**Counterparty** means the person opposite whom a covered swap entity executes a swap.

**Covered swap entity** means a swap dealer or major swap participant for which there is no prudential regulator.

**Custodian** means a person selected by the parties to a swap to hold margin on their behalf.

**Financial entity** means a counterparty that is not a swap dealer or a major swap participant and that is one of the following:

(1) A commodity pool as defined in Section 1a(5) of the Act,

(2) A private fund as defined in Section 202(a) of the Investment Advisors Act of 1940,

(3) An employee benefit plan as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income and Security Act of 1974,

(4) A person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature as defined in Section 4(k) of the Bank Holding Company Act of 1956,

(5) A person that would be a financial entity described in paragraph (1) or (2) if it were organized under the laws of the United States or any State thereof;

(6) The government of any foreign country or a political subdivision, agency, or instrumentality thereof; or

(7) Any other person the Commission may designate.

*Initial margin* means money, securities, or property posted by a party to a swap as performance bond to cover potential future exposures arising from changes in the market value of the position.

*Liquidation time horizon* means the time period needed to replace a swap.

*Minimum transfer amount* means an initial margin or variation margin amount that is less than \$100,000.

*Non-financial entity* means a counterparty that is not a swap dealer, a major swap participant, or a financial entity.

*Regulatory capital* means the amount of capital required under § 23.101 of this part.

*Significant swaps exposure* means

(1) Swap positions that equal or exceed either of the following thresholds:

(i) \$2.5 billion in daily average aggregate uncollateralized outward exposure; or

(ii) \$4 billion in daily average aggregate uncollateralized outward exposure plus daily average aggregate potential outward exposure.

(2) For purposes of this definition the terms daily average aggregate uncollateralized outward exposure and daily average aggregate potential outward exposure each has the meaning specified for that term in § 1.3(uuu) of this part for purposes of calculating substantial counterparty exposure under that regulation.

*State insurance regulator* means an insurance authority of a State that is engaged in the supervision of insurance companies under State insurance law.

*Stress test* means a test that compares the impact of a potential extreme price move, change in option volatility, or

change in other inputs that affect the value of a position, to the initial margin held for that position to measure the adequacy of such initial margin.

*Swap trading relationship documentation* means the documentation described in § 23.504 of this part.

*Threshold* means an amount below which initial margin or variation margin that otherwise would be due is not required to be paid.

*Uncleared swap* means a swap executed after the effective date of this rule that is not submitted for clearing to a derivatives clearing organization.

*Variation margin* means a payment made by a party to a swap to cover the current exposure arising from changes in the market value of the position since the trade was executed or the previous time the position was marked to market.

#### **§ 23.151 Documentation of credit support arrangements.**

(a) Each covered swap entity shall execute with each counterparty swap trading relationship documentation regarding credit support arrangements that complies with the requirements of § 23.504 of this part and this subpart E.

(b) The credit support arrangements shall specify the following:

(1) The methodology to be used to calculate initial margin for uncleared swaps entered into between the covered swap entity and the counterparty;

(2) The methodology to be used to calculate variation margin for uncleared swaps entered into between the covered swap entity and the counterparty;

(3) To the extent that the alternative method is used pursuant to § 23.155(c), the parties shall specify the reference contracts to be used;

(4) Any thresholds below which initial margin need not be posted by the counterparty; and

(5) Any thresholds below which variation margin need not be paid by the counterparty.

#### **§ 23.152 Margin treatment for uncleared swaps between covered swap entities and swap dealers or major swap participants.**

(a) *Initial margin.* (1) On or before the date of execution of an uncleared swap between a covered swap entity and a swap dealer or major swap participant, each covered swap entity shall require the counterparty to post initial margin equal to or greater than an amount calculated pursuant to § 23.155 of this part with a custodian selected pursuant to § 23.158 of this part.

(2) Until such an uncleared swap is liquidated, each covered swap entity shall require the counterparty to maintain initial margin equal to or

greater than an amount calculated pursuant to § 23.155 of this part with a custodian selected pursuant to § 23.158 of this part.

(3) If the credit support arrangements with a counterparty require the counterparty to post and/or maintain an amount greater than the amount calculated pursuant to § 23.155 of this part, the covered swap entity shall require the counterparty to post and/or maintain such greater amount.

(4) Each covered swap entity shall require the counterparty to post and maintain the entire initial margin amount required under this paragraph (a) unless the amount is less than the minimum transfer amount. There shall be no other exceptions for amounts below a threshold.

(b) *Variation margin.* (1) For each uncleared swap between a covered swap entity and a swap dealer or major swap participant, each covered swap entity shall require the counterparty to pay variation margin as calculated pursuant to § 23.156 of this part directly to the covered swap entity or to a custodian selected pursuant to § 23.158 of this part. Such payments shall start on the business day after the swap is executed and continue each business day until the swap is liquidated.

(2) For each uncleared swap between a covered swap entity and a swap dealer or major swap participant, each covered swap entity shall require the counterparty to pay the entire variation margin amount as calculated pursuant to § 23.156 of this part when due unless the amount is less than the minimum transfer amount. There shall be no other exceptions for amounts below a threshold.

(3) To the extent that more than one uncleared swap is executed pursuant to swap trading relationship documentation between a covered swap entity and its counterparty, a covered swap entity may calculate and comply with the variation margin requirements of this paragraph on an aggregate basis with respect to all uncleared swaps governed by such agreement, so long as the covered swap entity complies with these variation margin requirements with respect to all uncleared swaps governed by such agreement regardless of whether the uncleared swaps were entered into on or after the effective date.

(4) A covered swap entity shall not be deemed to have violated its obligation to collect variation margin from a counterparty if:

(i) The counterparty has refused or otherwise failed to provide the required variation margin to the covered swap entity; and

(ii) The covered swap entity has:

(A) Made the necessary efforts to attempt to collect the required variation margin, including the timely initiation and continued pursuit of formal dispute resolution mechanisms, or has otherwise demonstrated upon request to the satisfaction of the Commission that it has made appropriate efforts to collect the required variation margin; or

(B) Commenced termination of the swap or security-based swap with the counterparty.

**§ 23.153 Margin treatment for uncleared swaps between covered swap entities and financial entities.**

(a) *Initial margin.* (1) On or before the date of execution of an uncleared swap between a covered swap entity and a financial entity, the covered swap entity shall require the financial entity to post initial margin equal to or greater than an amount calculated pursuant to § 23.155 of this part. Upon request of the financial entity, the initial margin shall be held at a custodian selected pursuant to § 23.158 of this part.

(2) Until such an uncleared swap is liquidated, the covered swap entity shall require the financial entity to maintain initial margin equal to or greater than an amount calculated pursuant to § 23.155 of this part.

(3) If the credit support arrangements with a financial entity require the financial entity to post and/or maintain an amount greater than the amount calculated pursuant to § 23.158 of this part, the covered swap entity shall require the financial entity to post and/or maintain such greater amount.

(4) Except as provided in paragraph (c) of this section each covered swap entity shall require each financial entity to post and maintain the entire initial margin amount required under this paragraph (a) unless the amount is less than the minimum transfer amount.

(5) On or before the date of execution of an uncleared swap between a covered swap entity and a financial entity, the covered swap entity shall post any initial margin that may be required pursuant to the credit support arrangement between them.

(6) Until such an uncleared swap is liquidated, the covered swap entity shall maintain any initial margin that may be required pursuant to the credit support arrangement between them.

(7) The credit support arrangements between a covered swap entity and a financial entity may provide for a threshold below which the covered swap entity is not required to post initial margin.

(b) *Variation margin.* (1) For each uncleared swap between a covered swap

entity and a financial entity, each covered swap entity shall require the financial entity to pay variation margin as calculated pursuant to § 23.156 of this part directly to the covered swap entity or to a custodian selected pursuant to § 23.158 of this part. Such payments shall start on the business day after the swap is executed and continue each business day until the swap is liquidated.

(2) Except as provided in paragraph (c) of this section, for each uncleared swap between a covered swap entity and a financial entity, each covered swap entity shall require the financial entity to pay the entire variation margin amount as calculated pursuant to § 23.156 of this part when due unless the amount is less than the minimum transfer amount.

(3) For each uncleared swap between a covered swap entity and a financial entity, each covered swap entity shall pay any variation margin that may be required pursuant to the credit support arrangements between them.

(4) The credit support arrangements between a covered swap entity and a financial entity may provide for a threshold below which the covered swap entity is not required to pay variation margin.

(5) To the extent that more than one uncleared swap is executed pursuant to swap trading relationship documentation between a covered swap entity and its counterparty that permits netting, a covered swap entity may calculate and comply with the variation margin requirements of this paragraph on an aggregate basis with respect to all uncleared swaps governed by such agreement, provided that the covered swap entity complies with these variation margin requirements for all uncleared swaps governed by such agreement regardless of whether the uncleared swaps were entered into on or after the effective date.

(6) A covered swap entity shall not be deemed to have violated its obligation to collect variation margin from a counterparty if:

(i) The counterparty has refused or otherwise failed to provide the required variation margin to the covered swap entity; and

(ii) The covered swap entity has:

(A) Made the necessary efforts to attempt to collect the required variation margin, including the timely initiation and continued pursuit of formal dispute resolution mechanisms, or has otherwise demonstrated upon request to the satisfaction of the Commission that it has made appropriate efforts to collect the required variation margin; or

(B) Commenced termination of the swap or security-based swap with the counterparty.

(7) For risk management purposes, each covered swap entity shall calculate each day a hypothetical variation margin requirement for each such uncleared swap as if the counterparty were a swap dealer and compare that amount to any variation margin required pursuant to the credit support arrangements.

(c) *Thresholds.* (1) A covered swap entity may apply a threshold to the initial margin and variation margin requirements of a counterparty that is a financial entity if the counterparty makes the following representations to the covered swap entity in connection with entering into an uncleared swap with the covered swap entity:

(i) The counterparty is subject to capital requirements established by a prudential regulator or State insurance regulator;

(ii) The counterparty does not have a significant uncleared swaps exposure; and

(iii) The counterparty predominantly uses uncleared swaps to hedge or mitigate the risks of its business activities, including interest rate, or other risk arising from the business of the counterparty.

(2) The initial margin threshold shall be the lesser of [\$15 to 45] million or [0.1 to 0.3]% of the covered swap entity's regulatory capital.

(3) The variation margin threshold shall be the lesser [\$15 to 45] million or [0.1 to 0.3]% of the covered swap entity's regulatory capital.

**§ 23.154 Margin treatment for uncleared swaps between covered swap entities and non-financial entities.**

(a) *Initial margin.* (1) On or before the date of execution of an uncleared swap between a covered swap entity and a non-financial entity, the covered swap entity shall require such non-financial entity to post any initial margin that may be required pursuant to the credit support arrangement between them.

(2) Until such an uncleared swap is liquidated, the covered swap entity shall require the counterparty to maintain any initial margin that may be required pursuant to the credit support arrangement between them.

(3) The credit support arrangements between a covered swap entity and a non-financial entity may provide for a threshold below which the non-financial entity is not required to post initial margin.

(4) On or before the date of execution of an uncleared swap between a covered swap entity and a non-financial entity,

the covered swap entity shall post any initial margin that may be required pursuant to the credit support arrangement between them.

(5) Until such an uncleared swap is liquidated, the covered swap entity shall maintain any initial margin that may be required pursuant to the credit support arrangement between them.

(6) The credit support arrangements between a covered swap entity and a non-financial entity may provide for a threshold below which the covered swap entity is not required to post initial margin.

(7) For risk management and capital purposes, each covered swap entity shall calculate each day a hypothetical initial margin requirement for each such uncleared swap as if the counterparty were a swap dealer and compare that amount to any initial margin required pursuant to the credit support arrangements.

(b) *Variation margin.* (1) For each uncleared swap between a covered swap entity and a non-financial entity, each covered swap entity shall require the non-financial entity to pay any variation margin that may be required pursuant to the credit support arrangements between them.

(2) The credit support arrangements between a covered swap entity and a non-financial entity may provide for a threshold below which the non-financial entity is not required to pay variation margin.

(3) For each uncleared swap between a covered swap entity and a non-financial entity, each covered swap entity shall pay any variation margin that may be required pursuant to the credit support arrangements between them.

(4) The credit support arrangements between a covered swap entity and a non-financial entity may provide for a threshold below which the covered swap entity is not required to pay variation margin.

(5) To the extent that more than one uncleared swap is executed pursuant to swap trading relationship documentation between a covered swap entity and its counterparty that permits netting, a covered swap entity may calculate and comply with the variation margin requirements of this paragraph on an aggregate basis with respect to all uncleared swaps governed by such agreement, provided that the covered swap entity complies with these variation margin requirements for all uncleared swaps governed by such agreement regardless of whether the uncleared swaps were entered into on or after the effective date.

(6) For risk management purposes, each covered swap entity shall calculate each day a hypothetical variation margin requirement for each such uncleared swap as if the counterparty were a swap dealer and compare that amount to any variation margin required pursuant to the credit support arrangements.

#### **§ 23.155 Calculation of initial margin.**

(a) *Means of calculation.* (1) Each covered swap entity shall calculate initial margin using the methodology specified in the credit support arrangements with the counterparty provided that the methodology shall be consistent with the requirements of this section.

(2) Each covered swap entity shall calculate initial margin for itself and for each counterparty that is a swap dealer, major swap participant, or financial entity, using either:

(i) A risk-based model that meets the requirements of paragraph (b) of this section; or

(ii) The alternative method set forth in paragraph (c) of this section.

(b) *Models.* (1) *Eligibility.* To be eligible for use by a covered swap entity, a model shall meet the standards set forth in paragraph (b)(2) of this section, be filed with the Commission by a covered swap entity pursuant to paragraph (b)(3), be approved by the Commission pursuant to paragraph (b)(4) of this section and either be:

(i) Currently used by a derivatives clearing organization for margining cleared swaps;

(ii) Currently used by an entity subject to regular assessment by a prudential regulator for margining uncleared swaps; or

(iii) Made available for licensing to any market participant by a vendor.

(2) *Standards.* Each model shall conform to the following standards:

(i) The valuation of each uncleared swap shall be determined consistent with the requirements of § 23.504(b) of this part;

(ii) The model shall have a sound theoretical basis and significant empirical support;

(iii) The model shall use factors sufficient to measure all material risks;

(iv) To the extent available, the model shall use at least one year of historic price data and must incorporate a period of significant financial stress appropriate to the uncleared swaps to which the model is applied;

(v) Any portfolio offsets or reductions shall have a sound theoretical basis and significant empirical support;

(vi) The model shall set margin to cover at least 99% of price changes by

product and by portfolio over at least a 10-day liquidation time horizon;

(vii) The model must be validated by an independent third party before being used and annually thereafter;

(viii) The methodology shall be stated with sufficient specificity to allow the counterparty, the Commission, and any applicable prudential regulator to calculate the margin requirement independently;

(ix) The covered swap entity shall monitor margin coverage each day;

(x) The covered swap entity shall conduct back tests at least monthly;

(xi) The covered swap entity shall conduct stress tests at least monthly;

(xii) The covered swap entity shall document all material aspects of its valuation procedures and initial margin model; and

(xiii) If an uncleared swap or portfolio is available for clearing by a derivatives clearing organization but is not subject to mandatory clearing, the model shall include a factor requiring that the initial margin shall be equal to or greater than an amount that would be required by the derivatives clearing organization.

(3) *Filing with the Commission.* (i) Each covered swap entity shall file each model that it uses with the Commission.

(ii) The filing shall include a complete explanation of:

(A) The manner in which the model meets the requirements of this section;

(B) The mechanics of the model;

(C) The theoretical basis of the model;

(D) The empirical support for the model; and

(E) Any independent third party validation of the model.

(4) *Commission action.* (i) The Commission may approve or deny the application, or approve an amendment to the application, in whole or in part, subject to any conditions or limitations the Commission may require, if the Commission finds the approval to be necessary or appropriate in the public interest after determining, among other things, whether the applicant has met the requirements of this section and is in compliance with other applicable rules promulgated under the Act and by self-regulatory organizations.

(ii) The Commission may at any time require a covered swap entity to provide further data or analysis concerning a model.

(iii) The Commission may at any time require a covered swap entity to modify a model to address potential vulnerabilities.

(iv) At any time after the effective date of this rule, the Commission may in its sole discretion determine by written order that covered swap entities may apply for approval under this section to

calculate initial margin using proprietary models.

(c) *Alternative Method.* If a model meeting the standards set forth in paragraph (b) of this section is not used, initial margin shall be calculated in accordance with this paragraph.

(1) *General rule.* Initial margin shall be calculated as follows:

(i) The covered swap entity shall identify in the credit support arrangements the swap cleared by a derivatives clearing organization in the same asset class as the uncleared swap for which the terms and conditions most closely approximate the terms and conditions of the uncleared swap. If there is no cleared swap whose terms and conditions closely approximate the uncleared swap, the covered swap entity shall identify in the credit support arrangements the futures contract cleared by a derivatives clearing organization in the same asset class as the uncleared swap which most closely approximates the uncleared swap and would be most likely to be used to hedge the uncleared swap.

(ii) The covered swap entity shall calculate the number of units of the cleared swap or cleared futures contract necessary to equal the size of the uncleared swap.

(iii) The covered swap entity shall ascertain the margin the derivatives clearing organization would require for a position of the size identified in paragraph (c)(1)(ii) of this section.

(iv) The covered swap entity shall multiply the amount ascertained in paragraph (c)(1)(iii) of this section for a cleared swap by 2.0 in order to determine the margin required for the uncleared swap or multiply the amount ascertained in paragraph (c)(1)(iii) of this section for a cleared futures contract by 4.4 in order to determine the margin required for the uncleared swap.

(2) *Portfolio-based reductions.* (i) Reductions in margin based on offsetting risk characteristics of products shall not be applied across asset classes except that reductions may be applied between the currency asset class and the interest rate asset class.

(ii) Any reductions in margin based on offsetting risk characteristics of products within an asset class shall have a sound theoretical basis and significant empirical support.

(iii) No reduction shall exceed 50% of the amount that would be required for the uncleared swap in the absence of a reduction.

(3) *Modifications for particular products or positions.* Each covered swap entity shall monitor the coverage provided by margin established

pursuant to this paragraph (c) and collect additional margin if appropriate to address the risk posed by particular products or positions.

(4) *Commission action.* (i) The Commission may at any time require a covered swap entity to post or collect additional margin because of additional risk posed by a particular product.

(ii) The Commission may at any time require a covered swap entity to post or collect additional margin because of additional risk posed by a particular party to the uncleared swap.

#### **§ 23.156 Calculation of variation margin.**

(a) *Means of calculation.* (1) Each covered swap entity shall calculate variation margin using a methodology specified in the credit support arrangements with the counterparty.

(2) Each covered swap entity shall calculate variation margin for itself and for each counterparty that is a swap dealer, major swap participant, or financial entity using a methodology that meets the requirements of paragraph (b) of this section.

(b) *Methodology.* Each methodology shall conform to the following standards:

(1) The valuation of each swap shall be determined consistent with the requirements of § 23.504(b) of this part;

(2) The variation methodology must be stated with sufficient specificity to allow the counterparty, the Commission, and any applicable prudential regulator to calculate the margin requirement independently.

(c) *Commission action.* (1) The Commission may at any time require covered swap entity to provide further data or analysis concerning the methodology, including:

(i) An explanation of the manner in which the methodology meets the requirements of this section;

(ii) A description of the mechanics of the methodology;

(iii) The theoretical basis of the methodology; and

(iv) The empirical support for the methodology.

(2) The Commission may at any time require a covered swap entity to modify the methodology to address potential vulnerabilities.

#### **§ 23.157 Forms of margin.**

(a) *Initial margin.* (1) Each covered swap entity shall post and accept as initial margin only assets specified in the credit support arrangements with the counterparty.

(2) Each covered swap entity shall post and accept as initial margin only the following assets if the counterparty

is a swap dealer, a major swap participant, or a financial entity:

(i) Immediately available cash funds denominated in U.S. dollars or the currency in which payment obligations under the swap are required to be settled;

(ii) Any obligation which is a direct obligation of, or fully guaranteed as to principal and interest by, the United States or an agency of the United States; or

(iii) Any senior debt obligation of the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation, or any obligation that is an "insured obligation," as that term is defined in 12 U.S.C. 2277a(3), of a Farm Credit System bank.

(3) Each covered swap entity shall accept as initial margin from non-financial entities only assets for which the value is reasonably ascertainable on a periodic basis in a manner agreed to by the parties in the credit support arrangements.

(4) A covered swap entity may not collect, as initial margin or variation margin required by the part, any asset that is an obligation of the counterparty providing such asset.

(b) *Variation margin.* (1) Each covered swap entity shall pay and collect as variation margin only assets specified in the credit support arrangements with the counterparty.

(2) Each covered swap entity shall pay and collect as variation margin only cash or United States Treasury securities if the counterparty is a swap dealer, a major swap participant, or a financial entity.

(3) Each covered swap entity shall accept as variation margin from non-financial entities only assets for which the value is reasonably ascertainable on a periodic basis in a manner agreed to by the parties in the credit support arrangements.

(c) *Haircuts.* (1) Each covered swap entity shall apply haircuts to any asset posted or received as margin as specified in the credit support arrangements with the counterparty.

(2) Each covered swap entity shall apply haircuts to any asset received as margin that reflect the credit and liquidity characteristics of the asset.

(3) Each covered swap entity shall apply haircuts, at a minimum, to assets received as margin if the counterparty is a swap dealer, a major swap participant, or a financial entity in accordance with the following table:

**MARGIN VALUE RANGES FOR NON-CASH COLLATERAL**  
[% of market value]

	Duration (years)		
	0–5	5–10	> 10
(i) U.S. Treasuries and Fully Guaranteed Agencies:			
(A) Bills/Notes/Bonds/Inflation Indexed .....	[98–100]	[95–99]	[94–98]
(B) Zero Coupon, STRIPs .....	[97–99]	[94–98]	[90–94]
(ii) FHFA–Regulated Institutions Obligations and Insured Obligations of FCS Banks:			
(A) Bills/Notes/Bonds .....	[96–100]	[94–98]	[93–97]
(B) Zero Coupon .....	[95–99]	[93–97]	[89–93]

(d) *Commission action.* (1) The Commission may at any time require a covered swap entity to provide further data or analysis concerning any margin asset posted or received.

(2) The Commission may at any time require a covered swap entity to replace a margin asset posted to a counterparty with a different margin asset to address potential risks posed by the asset.

(3) The Commission may at any time require a covered swap entity to require a counterparty that is a swap dealer, a major swap participant, or a financial entity to replace a margin asset posted with the covered swap entity with a different margin asset to address potential risks posed by the asset.

(4) The Commission may at any time require a covered swap entity to provide further data or analysis concerning margin haircuts.

(5) The Commission may at any time require a covered swap entity to modify a margin haircut applied to an asset received from a swap dealer, a major swap participant, or a financial entity to address potential risks posed by the asset.

**§ 23.158 Custodial arrangements.**

(a) *Location of assets.* (1) Each covered swap entity shall specify in the credit support arrangements with each counterparty where margin assets will be held.

(2) Each covered swap entity shall offer each counterparty the opportunity to select a custodian that is not affiliated with the swap dealer or major swap participant.

(3) Each covered swap entity shall hold initial margin received from a counterparty that is a swap dealer or major swap participant at a custodian that is independent of the covered swap entity and of the counterparty.

(4) Each covered swap entity that posts initial margin with a counterparty that is a swap dealer or major swap participant shall require that the counterparty hold initial margin received at a custodian that is independent of the covered swap entity and of the counterparty.

(5) The independent custodian shall be located in a jurisdiction that applies the same insolvency regime to the custodian as would apply to the covered swap entity.

(b) *Use of assets.* (1) For each uncleared swap between a covered swap entity and a swap dealer, major swap participant, or a financial entity, the covered swap entity shall enter into a tri-party custodial agreement with the counterparty and the custodian that provides that:

(i) Neither the covered swap entity nor the counterparty may rehypothecate margin assets;

(ii) The custodian may not rehypothecate margin assets;

(iii) The custodian may not reinvest any margin held by the custodian in any asset that would not qualify as eligible collateral under § 23.157(a) of this part;

(iv) Upon certification in accordance with 23.602(b)(1) by one of the parties that it is entitled to control of the margin under the agreement, the custodian shall release the margin to the certifying party; and

(v) The certifying party shall indemnify the custodian against any claim that the margin assets should not have been released.

(2) Upon receipt of initial margin from a counterparty, no covered swap entity shall post such assets as margin for a swap, a security-based swap, a commodity for future delivery, a security, a security futures product, or any other product subject to margin.

(c) *Commission action.* (1) The Commission may at any time require a covered swap entity to provide further data or analysis concerning any custodian.

(2) The Commission may at any time require a covered swap entity to move assets held on behalf of a counterparty to another custodian to address risks posed by the original custodian.

Issued in Washington, DC, on April 12, 2011, by the Commission.

**David A. Stawick,**

*Secretary of the Commission.*

**Note:** The following appendices will not appear in the Code of Federal Regulations:

**Appendices To Swap Dealer and Major Swap Participant Margin Requirements for Uncleared Swaps—Commission Voting Summary and Statements of Commissioners**

**Appendix 1—Commission Voting Summary**

On this matter, Chairman Gensler and Commissioners Dunn, Sommers and Chilton voted in the affirmative; Commissioner O'Malia voted in the negative.

**Appendix 2—Statement of Chairman Gary Gensler**

I support the proposed rulemaking. Margin requirements for swaps that are not cleared between financial entities help ensure the safety and soundness of swap dealers and major swap participants.

The proposed rules would address margin requirements for uncleared swaps entered into by nonbank swap dealers or major swap participants. The prudential regulators today are proposing margin rules for the dealers that they regulate. For trades between swap dealers (or major swap participants), the rules would require paying and collecting initial and variation margin for each trade. For trades between swap dealers (or major swap participants) and financial entities, the rules would require the dealer (or major swap participant) to collect, but not pay, initial and variation margin for each trade, subject in certain circumstances to permissible thresholds. The proposed rule allows thresholds for margin for financial entities where they are subject to capital requirements established by a prudential regulator or a State insurance regulator and they are using their uncleared swaps to hedge or mitigate risk of their business activities.

The proposed rule would not require margin to be paid or collected on transactions involving non-financial end-users hedging or mitigating commercial risk. Congress recognized the different levels of risk posed by transactions between financial entities and those that involve non-financial entities, as reflected in the non-financial end-user exception to clearing. Transactions involving

non-financial entities do not present the same risk to the financial system as those solely between financial entities. The risk of a crisis spreading throughout the financial system is greater the more interconnected financial companies are to each other. Interconnectedness among financial entities allows one entity's failure to cause uncertainty and possible runs on the funding of other financial entities, which can spread risk and economic harm throughout the economy.

CFTC staff worked very closely with prudential regulators to establish initial and variation margin requirements that are comparable to the maximum extent practicable.

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## POSTAL SERVICE

### 39 CFR Part 111

#### Intelligent Mail Package Barcode (IMpb) Implementation for Commercial Parcels

**AGENCY:** Postal Service™.

**ACTION:** Proposed rule.

**SUMMARY:** The Postal Service is proposing to revise *Mailing Standards of the United States Postal Service*, Domestic Mail Manual (DMM®) to require the use of a unique tracking barcode on all commercial parcels, except Standard Mail® parcels, claiming presort and destination entry pricing by January 2012; and to encourage use of unique tracking barcodes by providing free Delivery Confirmation® service on all commercial parcels except Standard Mail parcels.

**DATES:** Submit comments on or before May 31, 2011.

**ADDRESSES:** Mail or deliver written comments to the manager, Product Classification, U.S. Postal Service, 475 L'Enfant Plaza SW., Room 4446, Washington, DC 20260-5015. You may inspect and photocopy all written comments at USPS® Headquarters Library, 475 L'Enfant Plaza SW., 11th Floor North, Washington, DC, between 9 a.m. and 4 p.m., Monday through Friday. E-mail comments, containing the name and address of the commenter, may be sent to: [MailingStandards@usps.gov](mailto:MailingStandards@usps.gov), with a subject line of "IMpb." Faxed comments are not accepted.

**FOR FURTHER INFORMATION CONTACT:** Juliaann Hess at 202-268-7663 or Kevin Gunther at 202-268-7208.

**SUPPLEMENTARY INFORMATION:** The Postal Service is currently enhancing its operational capability to allow for the scanning of Intelligent Mail® package

barcodes (IMpb) and other extra services barcodes via automated processing equipment and Intelligent Mail scanning devices. Once fully implemented, tracking data, including acceptance, enroute, and delivery status data, will be available for use by commercial mailers who use extra services on their packages.

IMpb can offer a number of additional benefits by allowing the potential for mailers to access piece-level visibility throughout USPS processing and delivery operations. The IMpb will include:

- A routing code to facilitate the processing of packages on automated sorting equipment.
- A channel-specific Application Identifier (AI) that associates the barcode to the payment method, supporting revenue assurance.
- A 3-digit service type code, which will identify the exact mail class and service combination, eliminating the need for multiple barcodes on a package.
- An option to use a 6-digit or 9-digit numeric Mailer ID (MID), to accommodate all mailers.

These enhancements will add data-stream efficiency within mail processing, delivery, payment, and reporting. Intelligent Mail package barcodes also include specific "mail class only" service type codes that may be used for packages without extra services.

To increase IMpb use within the mailing community, the Postal Service proposes to encourage use of unique tracking barcodes by including Delivery Confirmation at no additional charge on all commercial parcels except Standard Mail parcels; and to require the use of a unique tracking barcode on all commercial parcels (except Standard Mail parcels) claiming presort and destination entry pricing.

The provision that allows Delivery Confirmation to be offered without charge requires prior action by the Postal Service Board of Governors and the Postal Regulatory Commission. Assuming such action is completed as intended, the Postal Service proposes to make these new standards effective concurrent with the effective date of the first market dominant price change in 2012 (or January 2012, if no market dominant price change is scheduled for early 2012). The Postal Service plans to provide an optional-use transitional period, until June 4, 2012, to allow mailers sufficient time to effect the necessary changes to their software and systems. Merchandise Return Service (MRS) mailpieces and Business Reply Mail®(BRM) parcels would also qualify

for free Delivery Confirmation service at no charge.

Except for users of PC Postage®, the Postal Service proposes to require an Intelligent Mail package barcode (IMpb) for all parcels that include tracking or extra services and all parcels claiming presort and destination entry pricing, effective June 3, 2013. In addition, the Postal Service proposes to require use of version 1.6 Shipping Services Electronic Manifest Files by June 3, 2013; and to require that these files include each destination ZIP + 4® code, or each destination delivery address by that date. This new file format will also require a new version of the customer extract file. The Postal Service proposes to require all parcels shipped using PC Postage systems to bear a IMpb, and to use version 1.6 Shipping Services Electronic Manifest, by June 4, 2012.

To support future sorting efficiencies, the USPS strongly encourages mailers to place a ZIP + 4 code or destination address in the electronic files for each mailpiece as soon as possible. Mailers using the IMpb are also encouraged to include the additional two-digit delivery point code in the electronic file. The Postal Service proposes to require mailers to include the destination ZIP + 4 code (or destination address) in the electronic file for all records by June 3, 2013.

These proposed standards will also require a postal routing code on all parcels and Priority Mail pieces, preferably as a concatenated IMpb or extra services barcode. When a concatenated IMpb or extra services barcode is not used, a separate postal routing barcode must be included in addition to the IMpb. Flat or letter-shaped Priority Mail® or Critical Mail™ pieces may use the Intelligent Mail barcode (IMb) or POSTNET for the postal routing barcode.

Under these proposed standards, (except for Standard Mail) mailers of presorted parcels, parcels claiming destination entry prices, or parcels bearing PC Postage, and who do not purchase a trackable extra service, or make use of the Delivery Confirmation service provided at no charge, must use (at a minimum) a "mail-class only" IMpb service type code that represents the class or subclass of the mailpiece that is being shipped.

The Postal Service also proposes to modify the current requirement for mailers to use an extra service-specific, human-readable, service banner text format when printing an IMpb. Current standards require a different human-readable service banner text for each extra service selected by the mailer. The Postal Service proposes to provide only