Regulatory Initial Margin (IM) Requirements – Time to Get Ready

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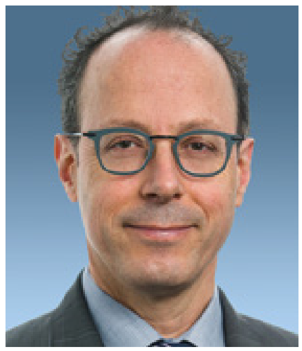

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The time to get ready is now. Investment funds with "material swaps exposure" greater than $8 billion will be subject to the regulatory initial margin (IM) requirements as of September 1, 2020. Under the IM rules, these funds will be required to post and collect initial margin to and from their dealer counterparties. Compliance with these IM requirements will take significant time, preparation and effort to ensure that all necessary documentation and processes are ready.

While ongoing lobbying efforts had raised hopes that the material swaps exposure threshold might be increased, thus reducing the number of investment funds that would be in scope, recent statements and related guidance from the supra-national regulatory bodies suggests that this form of relief will not be forthcoming. A limited form of relief has been offered that may modestly reduce the burden of compliance, the nature and scope of which will be discussed further below.

Investment managers whose funds have large derivatives books will need to determine whether they are in-scope and potentially subject to the IM requirements for purposes of the September 2020 phase-in. This will require them to assess their material swaps exposure for the months of June, July and August of 2019 for the U.S. rules, and March, April and May of 2020 for the EMIR (EU) rules. The implications of being in-scope include changes in how IM will be determined, bilateral exchange of IM, and preparation and negotiation of the documentation and custody arrangements required under the rules. This article provides a brief overview of what investment managers will need to consider as they prepare for implementation of the IM rules.

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1. Who is in-scope? The "material swaps exposure" question

Under the U.S. IM rules, a buy-side firm that is a "financial end user" (*e.g.,* public and private investment fund, family office, pension plan, etc.) will be subject to the IM requirements if it has material swaps exposure. A fund or investor will have material swaps exposure if it, together with its affiliates (under accounting consolidation principles), has an average daily aggregate notional amount ("AANA") of non-cleared swaps with all counterparties for June, July and August of the prior calendar year of greater than $8 billion.

Application under the EMIR IM rules is largely analogous, although the AANA determination is made in March, April and May of the same year, and is determined on the basis of the gross notional exposure as of the last business day of each month, as averaged for the three months. Investment managers should consult with UK/EU counsel for advice related to compliance under the EMIR IM rules.

Note that institutional investors that invest across multiple investment managers in separately managed accounts will need to aggregate the swap exposure across all investment managers. If they haven't already, investment managers should contact their account principals to ensure that those principals have started the process of determining their material swaps exposure.

The U.S. rules require tracking the daily swap exposure for every business day over the entire three-month period, so that these can be added up and averaged. By contrast, the EMIR IM rules require determining the AANA on the last business day of each month in the period. As evident, there are many more data points to

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factor under the U.S. IM rules.

Under the U.S. IM rules, investment managers need to look at the gross notional amount of all non-cleared swaps, including CFTC-regulated swaps, SEC-regulated security-based swaps, and FX swaps and forwards. Although the notional amount of FX swaps and forwards is included in the material swaps exposure calculation, these trades are not subject to the U.S. IM requirements.

Firms that are near the threshold (whether below or above) will need to continue to monitor their AANA every year to determine whether they may be phased-in or phased-out because of a change in status. As material swaps exposure under the IM rules is a backward-looking test, a change in status will be effective on January 1 of the year following the determination. This means that if a fund did not have material swaps exposure for 2019, and was not phased-in for September 2020, but subsequently determines that it has material swaps exposure for any year following 2019, that fund will have seven months to prepare for implementation under the EMIR AANA determination, and only four months to prepare under the U.S. AANA determination.

2. The material swaps exposure determination under the U.S. IM rules

These examples illustrate how the material swaps exposure determination works for purposes of the September 1, 2020 phase-in under the U.S. IM rules.

Example 1:

- Fund A averages its gross notional swap exposure for every business day over the calculation period and determines that its AANA for June, July and August of 2019 is $8.2 billion. Fund A is in-scope for phase-in on September 1, 2020.

- Note: Fund A will remain in scope for September 2020 phase-in even if its AANA should subsequently decline and fall below the $8 billion threshold. Unlike the requirements for the earlier phase-in dates, there is no additional "current year" AANA determination for the September 2020 phase-in.

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Example 2:

- Fund B determines that its AANA for June, July and August of 2019 is $6.9 billion. It is not in scope for phase-in on September 1, 2020.

- However, Fund B experiences strong growth and puts on additional swap positions, such that its AANA for June, July and August of 2020 is $8.5 billion. Fund B will therefore have material swaps exposure as of January 1, 2021, and will be subject to the IM requirements from that date forward.

- Note: Under this scenario, Fund B has only 4 months to prepare for implementation. However, Fund B would have more time to prepare if it made its AANA determination for EMIR IM rule purposes in March, April and May of 2020, as it is likely that the determinations would provide largely consistent results under both the U.S. and EMIR IM rules.

Example 3:

- Fund C was phased-in on September 1, 2020 because it had material swaps exposure of $8.5 billion as determined over June, July and August of 2019.

- Fund C subsequently determines that its AANA for June, July and August of 2020 was $8.2 billion, which means that it has material swaps exposure for purposes of the 2021 calendar year and will continue to be subject to the IM requirements.

- Fund C then determines that its AANA for June, July and August of 2021 is $7.5 billion. Fund C will not have material swaps exposure as of January 1, 2022, and will not be subject to the IM requirements from that date forward. However, Fund C should continue to monitor its AANA for the calculation period in subsequent years in the event its swaps exposure should increase and potentially change its status.

3. How IM practice may be different under the IM requirements

Under current market practice, swap dealers will typically require buy-side firms to post initial margin on a one-way basis. The amount of IM required is based on the dealer's proprietary risk management process, which considers market risk, volatility, counterparty credit risk and other factors. Different dealers can offer different levels of IM for the same trade, and investment managers frequently consider the amount of IM required when they seek pricing and execution from dealer swap desks.

Under the IM requirements, IM levels are determined using either the IM look-up table established under the IM rules, or by using an IM model that has been approved by the regulators. ISDA has developed the Standard Initial Margin Model (SIMM), which has been approved and is currently being used by dealers to determine IM levels in compliance with the IM requirements. It is expected that dealers will continue to use SIMM as their benchmark for determining IM levels for

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counterparties that will be phased-in for September 2020.

One of the most important features of IM practice under the IM requirements, as compared to current practice, is that IM is posted on a two-way basis. The two-way IM requirement will be mitigated by the availability of a "threshold amount" of up to $50 million, which could keep the first $50 million of initial margin from having to be posted. However, this threshold will likely be used to reduce only the amount of IM that dealers will need to post, and investment funds will likely be subject to a $0 threshold for IM they are required to post. Furthermore, the availability of the threshold may not eliminate the need to put in place the necessary custody and account control arrangements, as will be discussed below.

4. BCBS/IOSCO provide limited compliance relief

The Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) recently published guidance acknowledging the burdens of putting in place documentation, custodial and operational arrangements.[i] The statement notes that the BCBS/IOSCO framework for the uncleared swap margin rules, which underpins the IM rules promulgated in the U.S. and under EMIR, *"does not specify documentation, custodial or operational requirements if the bilateral initial margin amount does not exceed the framework's €50 million initial margin threshold" but that "[I]t is expected, however, that covered entities will act diligently when their exposures approach the threshold to ensure that the relevant arrangements needed are in place if the threshold is exceeded."*

Assuming this guidance is confirmed by U.S. regulators, this would allow parties to defer implementation of the documentation, custody and operational processes that will be required under the IM rules, provided the IM required to be transferred is below the threshold (which is set at $50 million under the U.S. IM rules). However, because the $50 million IM threshold is expected to apply only to swap dealers, and not their counterparties, the relief may only affect one side of the relationship – collateral custody and segregation arrangements would not be necessary to hold the IM posted by dealers (since they would not be posting IM), but might still be required to hold IM posted by their investment fund counterparties (because the threshold may not be available to them). One must also consider that $50 million is not that much IM for a large derivatives book, and that it is likely that IM requirements over $50 million will be common, mooting the relief in such cases.

5. IM determinations under the IM rules

The IM levels determined by dealers using the SIMM process may not differ substantially from the levels provided under current practice. However, it is important to note that the SIMM process only generates a minimum IM level for compliance purposes. Dealers are free to demand more IM for any given trade or client than results from the SIMM determination. Indeed, most dealers will likely use a "greater of" test in making IM determinations, running their SIMM and "house" models together, comparing the output, and demanding whichever level of IM is greater. Nonetheless, it is reasonable to expect that use of a benchmark such as SIMM might more closely align the IM levels offered by different dealers, and thus reduce the importance of IM when investment managers are assessing dealers for execution.

Many larger investment managers are currently vetting SIMM providers so that they may have direct access to SIMM to check the IM levels that their swap dealers will be requiring.

6. Documentation issues under the IM requirements

Among the documentation challenges that will have to be considered in preparing for compliance with the IM requirements are the following:

First, firms will need to agree and execute a separate IM rule-compliant Credit Support Annex (CSA). ISDA has published two new CSA templates: the 2018 Credit Support Annex for Initial Margin (IM) (Security Interest – New York law) and the 2018 Credit Support Deed for Initial Margin (IM) (Security Interest – English law). These are based on the ISDA 2016 Phase One Credit Support Annex/Deed for Initial Margin that was used by swap dealers for the earlier IM compliance phases. Because of the particular regulatory requirements related to IM, bespoke or ad hoc amendments to existing CSAs may not be readily offered or available, as was frequently the case for implementation of the swap variation margin requirements.

Second, because the IM rules require that all IM posted or collected under the regime be held in a segregated custodial account at an unaffiliated custodian, firms will need to negotiate and execute custody arrangements and account control agreements for *both* the IM that is posted *and* the IM that is collected. As noted above, limited regulatory relief may allow parties to arrange for custody of only the IM posted by investment funds. Custodians have account control agreement templates that have been vetted for regulatory compliance, but these may not include all the "Pledgor" protections that investment managers expect when negotiating segregated IM arrangements. It is also expected that custodians will establish deadlines for completing account documentation that may be months in advance of the September 2020 compliance date, to ensure that the necessary custodial accounts will be open by September 1.

7. Conclusion

Preparing for implementation of the IM requirements will not be easy. If an

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investment fund is in-scope for September 2020 phase-in, there are many issues that will need to be addressed between now and then. Beyond making the material swaps exposure determination, an in-scope firm will need to reach out to its dealer counterparties and to custodians to start the documentation process, consider using a SIMM vendor to have access to the benchmark IM levels, and assess the impact of regulatory IM on liquidity and returns. Early action on these issues will reap benefits and help to ensure an orderly and timely compliance process.

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[i] *BCBS/IOSCO statement on the final implementation phases of the Margin requirements for non-centrally cleared derivatives* (Mar. 5, 2019), available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD624.pdf.

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