ALERT MEMORANDUM

CFTC Proposes Amendments to Margin Requirements for Uncleared Swaps

September 11, 2023

On July 26, 2023, the Commodity Futures Exchange Commission ("**CFTC**") proposed amendments to its uncleared swap margin rules (the "**Margin Rules**")[1] to (i) deem, for three years after they begin trading, certain collective investment funds that receive all of their start-up capital, or a portion thereof, from a sponsor entity ("**Seeded Funds**") not to have any "margin affiliates" for the purposes of calculating whether initial margin ("**IM**") is required to be exchanged and (ii) eliminate a provision disqualifying money market funds and similar funds ("**MMFs**") that transfer their assets through securities lending, repurchase agreements, and other similar agreements from being used as eligible collateral (the "**Proposal**").[2] In addition, the Proposal would add a footnote to the haircut schedule for eligible collateral.

One CFTC Commissioner, Christy Goldsmith Romero, dissented from the Proposal. Comments on the Proposal must be received on or before October 10, 2023.

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[1] 17 C.F.R. §§ 23.150 – 23.161.

[2] *See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 88 Fed. Reg. 53409 (Aug. 8, 2023).

I. BACKROUND

1. The GMAC Subcommittee

The Proposal adopts recommendations of a subcommittee of market participants established by the CFTC's Global Markets Advisory Committee ("**GMAC**") (the "**Subcommittee**"). The GMAC established the Subcommittee in January 2020 to provide feedback and prepare a report with recommendations on the implementation of the CFTC's margin requirements for uncleared swaps. The GMAC voted to adopt the Subcommittee's report, and the Proposal is largely based on the recommendations in the report.

2. Margin Rules

The CFTC adopted the Margin Rules pursuant to the Section 4s(e) of the Commodity Exchange Act's ("**CEA**") requirement that the CFTC adopt rules establishing minimum initial margin ("**IM**") and variation margin ("**VM**") for swaps entered into by a swap dealer or major swap participant for which there is no prudential regulator ("**covered swap entities**," or "**CSEs**") and which are not cleared by a registered derivatives clearing organization ("**uncleared swaps**"). IM is the collateral collected and posted to cover potential future exposure in connection with an uncleared swap or a netting portfolio of uncleared swaps calculated using a standardized method or a risk-based model (*e.g.*, SIMM).[3] VM is the collateral exchanged to cover current exposure from one or more uncleared swaps calculated in reference to mark-to-market changes to the value thereof.[4]

The Margin Rules specifically require a CSE to collect and post IM in respect of swaps between such CSE and with a counterparty that is a financial end user ("**FEU**") with material swaps exposure ("**MSE**"), swap dealer, or major swap participant.[5] FEUs are certain entities, persons, and arrangements whose business is financial in nature, and includes many investment funds.[6] An FEU will have MSE if, as of September 1 of any year, the FEU *and* its margin affiliates have a month-end average aggregate notional amount ("**AANA**") of uncleared swaps, uncleared security-based swaps, foreign exchange forwards, and foreign exchange swaps above $8 billion with all counterparties for March, April, or May of that year. Absent an exemption, any investment fund with MSE will be in scope for IM requirement for a CSE once the amount of IM that would be required to be posted or collected between the fund and its margin affiliates, on one hand, and the CSE and its margin affiliates, on the other, would exceed $50 million (the "**IM threshold**").

Under the Margin Rules,[7] eligible collateral for IM includes cash denominated in a major currency or the currency of settlement for the uncleared swap, certain securities issued by the U.S. government or other sovereign entities, certain publicly-traded debt or equity securities, certain securities issued by MMFs (subject to the "asset transfer restriction," which prohibit the managers of the MMF from transferring the assets of the MMF through securities lending, repurchase agreements, or other means that involve the MMF having rights to acquire the same or similar assets from the transferee), and gold. Eligible collateral for IM is also eligible for VM if the relevant uncleared swaps are between a CSE and an FEU; only cash is eligible VM for swaps between CSEs. The Margin Rules also set forth applicable haircuts for IM and VM posted as collateral.

While the Margin Rules permit the posting of immediately-available cash funds denominated in a major currency or the currency of settlement for the uncleared swap to be posted as IM, the posted cash must be reinvested in another asset that would be eligible collateral under the Margin Rules. IM held in the form of a deposit liability with a custodian generally creates an unsecured debt liability of the custodian and, therefore, credit exposure to the custodian. The reinvestment must occur within a reasonable period of time necessary to consummate the purchase of such non-cash collateral, and the amount of eligible collateral must be sufficient to cover the IM amount in light of the applicable haircut on the non-cash collateral. The Margin Rules provide that certain pooled investment funds, including certain MMFs, are eligible collateral. MMFs are a commonly available automatic cash sweep option and thus an obvious reinvestment option for cash

[3] 17 C.F.R. §§ 23.152; 23.154.
[4] 17 C.F.R. § 23.151.
[5] *Id*.
[6] *Id*.
[7] 17 C.F.R. § 23.156.

collateral, especially when the relevant custodian is not itself providing a collateral optimization service.

The Subcommittee's report (the "**Report**") made the following findings and recommendations:

— The current criteria for determining whether a counterparty comes within the scope of the IM requirements unduly penalizes Seeded Funds. Because a Seeded Fund will generally be consolidated with its sponsor entity during the period in which the start-up capital provided by the sponsor entity exceeds that of third-party investors and represents up to 100 percent of the ownership interest in the fund ("**Seeding Period**"), the Seeded Fund will be a margin affiliate of the sponsor entity. As such, the Seeded Fund will be required to determine whether it has MSE on a consolidated basis with the sponsor entity and the sponsor entity's other margin affiliates, even though the Seeded Fund itself may only have a small swaps exposure.

— Regulators in other major financial markets have adopted the Basel Committee on Banking Supervision and Board of the International Organization of Securities Commission ("**BCBS-IOSCO**") for margin requirements for non-centrally cleared derivatives without requiring Seeded Funds to be consolidated with the sponsor and to be treated as a margin affiliate of the sponsor.

— Nearly all U.S. MMFs engage in some form of repurchase or similar arrangements, which would preclude MMFs from constituting eligible collateral under the Margin Rules. Notably, the Report cited research finding that the securities of only four MMFs would qualify as eligible collateral due to the asset transfer restriction in the Margin Rules.[8]

The CFTC considered the Subcommittee Report and issued the Proposal to modify the margin requirements such that:

— A Seeded Fund should be treated as a separate legal entity, not affiliated with its sponsor entity, for a period of three years for the purpose of determining whether a CSE should exchange IM with a seeded fund for their uncleared swaps; and

— The current restriction on the use of securities of MMFs that transfer their assets through repurchase and similar arrangements should be removed.

II. PROPOSAL

1. Seeded Funds Proposal

Under the Proposal, Seeded Funds which meet certain requirements would be deemed not to have any margin affiliates for the purpose of calculating the fund's MSE and the IM threshold for three years after the fund's trading inception date. The Proposal does so by amending the definition of "margin affiliate" and adding a definition of "eligible seeded fund" (collectively, "**Seeded Funds Proposal**").

An entity would continue to be considered a "margin affiliate" of another if either entity consolidates the other on a financial statement prepared in accordance with GAAP, *unless* the determination is made within three years after the date on which an eligible seeded fund's asset manager first begins to make investments on behalf of the fund. The eligible seeded-fund exception only applies for the purposes of calculating the fund's MSE and whether the IM threshold amount has been exceeded.

An "eligible seeded fund" would be one where:

— The Seeded Fund is a distinct legal entity from each sponsor entity;

— One or more of the Seeded Fund's margin affiliates is required to post and collect IM pursuant to the Margin Rules;

— The Seeded Fund is managed by an asset manager who manages the fund's assets in accordance with a specified written investment strategy;

— The asset manager has independence from the sponsor entity or the sponsor entity's affiliates and, to the extent applicable, has independent fiduciary duties to other investors in the fund, such that no sponsor entity or any of the sponsor entity's margin

[8] 17 C.F.R. § 23.156(a)(1)(ix).

affiliates controls or has transparency into the management or trading of the Seeded Fund;

— The Seeded Fund follows a written plan for reducing each sponsor entity's ownership over a three-year period that stipulates divestiture targets over the three-year period after the date on which the seeded fund's asset manager first begins to make investments on behalf of the fund;

— The Seeded Fund's obligations are not collateralized, guaranteed, or otherwise supported by any sponsor entity or sponsor entity's affiliate or other collective investment vehicle or the fund manager;

— The Seeded Fund has not received any of its assets from an eligible seeded fund that has itself relied on the eligible seeded fund exception; and

— The Seeded Fund is not a securitization vehicle.

Margin Affiliate Definition

The Proposal is intended to relieve CSEs from the obligation to exchange IM with counterparties that are Seeded Funds that themselves have only limited swaps exposure, for the first three years from the Seeded Fund's inception date. CSEs and Seeded Funds would continue to be relieved from the IM requirement for uncleared swaps entered into during that three-year period, even after the expiration of that period.

> Under the Proposal, CSEs and their other margin affiliates would still be required to count uncleared swaps entered into with Seeded Funds for the purposes of calculating their own AANA. CSEs would also be required to continue to exchange VM with Seeded Funds.

The Subcommittee, as well as other market participants, explained the recommendation as a way to ensure the Seeded Funds don't experience a "performance drag" since IM is an operational cost which may not be commensurate with the Seeded Fund's uncleared swap activity and risk. Further, Seeded Funds would otherwise be required to negotiate complex margin documentation, develop a complex compliance infrastructure, and hold larger cash reserves.

The CFTC highlighted that it would, in any event, require CSEs, in establishing a risk management program, to monitor and manage risks associated with their swap activities, to account for credit risk, and set risk tolerance limits separate from the Margin Rule's IM and VM requirements, regardless of whether IM is actually required.

Eligible Seeded Fund Definition

The CFTC's definition of "eligible seeded fund" is intended to allow Seeded Funds to emerge from the seeding phase by attracting unaffiliated investors and to discourage the sponsor entity from retaining control or influence over the Seeded Fund beyond that of a minority or passive investor. The Proposal also seeks to limit its reach to Seeded Funds that would have to exchange IM solely due to a sponsor entity's MSE.

The eligible seeded fund definition does not go so far as to consider the Seeded Funds as distinct, separate entities, for which the Subcommittee had advocated. The Proposal states that the CFTC believes that the definition of eligible seeded fund provides enough safeguards to prevent financial contagion between the sponsor entity and the eligible seeded fund.

Impact of the Proposal

The CFTC notes that the Seeded Funds Proposal exception is consistent with the approach in other jurisdictions such as Australia, Canada, and the EU, along with the BCBS-IOSCO Framework.

The CFTC noted that the Proposal is a departure from the prudential regulators' approach and so the CFTC is seeking comment on whether the Proposal should be adopted if the prudential regulators do not amend their uncleared swap margin rules to be consistent with the Proposal.[9]

Commissioner Christy Goldsmith Romero opposed the Seeded Funds Proposal on the basis that it would potentially increase risks related to uncleared swaps and undermine the requirements of the Dodd-Frank Act reforms.

[9] See Appendix A for a list of questions on which the CFTC is requesting comment.

Market participants should consider whether this Proposal, and in particular the conditions for qualifying as an "eligible seeded fund," would address concerns raised by the industry and the disparity with the uncleared margin rules of other jurisdictions. Consider, for example, whether a Seeded Fund that only has a margin affiliate that exchanges IM in compliance with the uncleared margin rules of a different U.S. or non-U.S. regulatory regime should be able to qualify as an eligible seeded fund.

2. Money Market Funds Proposal

The Proposal would amend the Margin Rule to eliminate the restriction on the use of MMFs that transfer their assets through securities lending, repurchase agreements, and other similar agreements such as eligible collateral and similar funds (the "**MMF Proposal**"). Presently, MMFs are permitted to be used as collateral for IM on cleared derivatives. The CFTC noted that it was making the change based on its experience implementing the Margin Rules and the fact that MMFs are subject to liquidity and diversification requirements and are required to invest in high quality underlying instruments such as Treasuries and cash.

By eliminating the asset transfer restriction, the Proposal would allow a broader range of MMF securities to qualify as eligible collateral.

Impact of the Proposal

The CFTC stated in the Proposal that the amendment could lead to more efficient collateral management practices as custodians often offer money market sweep programs, which could avoid settlement delays or additional costs associated with non-cash collateral. Additionally, custodian banks often charge a negative interest rate on cash collateral. The CFTC intended to address the potential concentration of margin collateral in securities of a few MMFs that do not use asset transfers and increase flexibility and safety, which would ultimately add to the stability of the financial system.

In the Proposal, the CFTC reminded CSEs that they are still required under the Margin Rules to monitor the market value and eligibility of all collateral, which could require the posting of additional eligible collateral.[10]

The industry has raised the concern that MMFs that would typically satisfy the conditions under the EU margin rules would not constitute eligible collateral under the Margin Rules because MMFs subject to the European legislative framework are generally *required* to invest in repurchase agreements or reverse repurchase agreements.

Further, the European Union ("**EU**") margin rules require that MMFs would need to constitute Undertakings for the Collective Investment in Transferable Securities ("**UCITS**"), as defined in the UCITS Directive, and therefore need to be established in the EU. As a result, MMFs established in jurisdictions other than member states of the EU, including US MMFs, would not constitute eligible collateral under the EU Margin Rules. This has been more favorably addressed by the UK regulators in its margin regulations.[11]

Commissioner Goldsmith Romero also opposed the MMF Proposal, pointing to the stress MMFs and the short-term funding market experienced during the financial crisis of 2008 and 2020 Covid-19 pandemic when institutional investors withdrew cash from MMFs

In light of the concerns raised by some in the industry in addition to those raised by the Commissioner regarding the introduction of risk, particularly by the Money Market Funds Proposal, those in favor of the Proposal may be well advised to submit supporting comments before the October 10 deadline.

For example, it may be well worth highlighting that the Proposal would not alter the requirement that eligible MMF would be limited to those that invest only in either (a)(i) securities unconditionally guaranteed as to the timely payment of principal and interest by the US

[10] 17 C.F.R. § 23.156(c).

[11] The Report noted that there are currently no MMFs that are eligible under both the EU Margin Rules and either the CFTC's Margin Rules or the USPR Margin Rules, which creates complications for FEUs that pledge IM to both U.S. and EU CSEs and asset managers trading in blocks across U.S. and EU clients with a single CSE. As such, the Report found that the lack of MMFs eligible under both EU and U.S. Margin Rules restricts viable options for eligible collateral and efficient collateral management. GMAC, RECOMMENDATIONS TO IMPROVE SCOPING AND IMPLEMENTATION OF INITIAL MARGIN REQUIREMENTS FOR NON-CLEARED SWAPS 25-28 (May 19, 2020).

Department of the Treasury and (ii) immediately-available cash funds denominated in US dollars; or (b)(i) securities denominated in a common currency and issued by, or fully guaranteed as to the payment of principal and interest by, the European Central Bank or a sovereign entity that is assigned no higher than a 20 percent risk weight under the capital rules applicable to swap dealers subject to regulation by a prudential regulator and (ii) immediately-available cash funds denominated in the same currency. The MMFs most impacted by "runnability" and "breaking the buck" in past crises were those who invested in a broader range of assets.

The CFTC also requested comments on whether it should consider an alternative to the Proposal, such that securities of money market and similar funds would qualify as eligible collateral only if a fund's repurchase or similar arrangements are cleared. Market participants may wish to consider whether that would be appropriate in the absence of a finalized clearing mandate for treasury repos and in the absence of a robust repo market for all securities which an eligible MMF may invest in as well as the impact on the eligibility of UCITS.

3. Haircut Schedule Amendment

The Proposal would amend the haircut schedule in CFTC to add a footnote to the haircut schedule, which was inadvertently omitted when the Margin Rules were originally promulgated. The footnote would describe the haircut applicable to securities of MMFs and similar funds, which would be the weighted average discount on all assets within the funds calculated as a fraction of each fund's total market value. The amendment would align the CFTC's haircut schedule with that of the prudential regulators and the approach adopted by many market participants.

4. Compliance Date

The CFTC did not propose a specific compliance date in the Proposal. Rather, the CFTC is seeking comments regarding the appropriate timeframe. The proposal sets out an extensive list of specific questions on which it is requesting comment and which we attach as Appendix A.

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APPENDIX A

The CFTC has requested comments regarding the Proposal, generally. The specific questions in the Proposal on which the CFTC requested comment are set out below.[12]

1. Under the Seeded Funds Proposal, eligible seeded funds would be deemed not to have margin affiliates for purposes of calculating the fund's MSE and the IM threshold amount during a period of three years from the fund's trading inception date. As such, CSEs that undertake uncleared swaps with such funds and would otherwise be required to exchange IM with the funds, may be relieved from such obligation, as only each fund's individual exposure would be considered in determining whether the IM requirements apply to uncleared swaps between CSEs and the fund. As a result, less margin may be collected and posted for uncleared swaps than would be otherwise required under the current requirements. Is the Seeded Funds Proposal appropriate in light of the resulting potential uncollateralized swap risk?
2. The Commission recognizes that the proposed eligible seeded fund exception would not only benefit the eligible seeded funds but would also relieve CSEs from their obligation to post IM with seeded funds that would otherwise come within the scope of the CFTC IM requirements. Should only the eligible seeded fund, and not its CSE counterparty, be relieved of the IM obligation?
3. Should the Commission impose any additional limits or conditions to the proposed eligible seeded fund exception such as: (i) imposing a separate MSE and/or IM threshold amount, calculated on the basis of the eligible seeded fund's individual exposure and proportionate to the perceived risks associated with funds' swap activities; (ii) imposing a limit on the total number of eligible seeded funds to which a sponsor entity provides start-up capital that may rely on the eligible seeded fund exception; or (iii) requiring that all eligible seeded funds, consolidated within the same group on the basis of accounting principles, aggregate their exposures for purposes of calculating the MSE and IM threshold amounts that apply to such funds?
4. What are the costs associated with a seeded fund calculating IM and establishing a relationship with a custodian to transfer IM?
5. The proposed amendments to Commission Regulation 23.151, in particular the requirements in the proposed definition of "eligible seeded fund," aim to ensure that the relevant funds are genuinely and practically independent and risk-remote from their sponsor entities and other affiliates. Do the proposed amendments incorporate sufficient safeguards to achieve this goal? Given that other entities such as sponsor entities or the asset manager may be incentivized to provide resources to a seeded fund in financial distress even in the absence of an explicit business arrangement or guarantee, potentially putting their own financial position at risk and thereby increasing the risk of contagion and systemic risk, what measures could the Commission take to limit the potential risks to such other entities and ultimately to the financial system?

[12] *See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 88 Fed. Reg. 53409 (Aug. 8, 2023).

6. The Commission proposes to include, among other conditions, a requirement providing that a fund would qualify as an eligible seeded fund only if one or more of the seeded fund's margin affiliates is required to post and collect IM pursuant to Commission Regulation 23.152. This condition is intended to limit the availability of the proposed eligible seeded fund exception only to funds that, for reasons described in the Margin Subcommittee Report, are disadvantaged domestically and globally due to their affiliation with a group that has MSE. Is this condition appropriate? Should the condition be amended to ensure that the Commission is appropriately circumscribing the proposed treatment of eligible seeded funds?

7. The Commission also proposes to include, among other conditions, a requirement providing that to qualify as an eligible seeded fund, the seeded fund's investment strategy must follow a written plan for reducing each sponsor entity's ownership interest in the seeded fund that stipulates divestiture targets over the three-year period after the seeded fund's trading inception date. Should the Commission include more specific requirements in connection with the written plan?

8. The Prudential Regulators Margin Rule contains a definition of "margin affiliate" that is equivalent to the current definition under the CFTC Margin Rule. Furthermore, the prudential regulators have reserved the right to include any entity as an affiliate or a subsidiary based on the conclusion that an entity may provide significant support to, or may be materially subject to the risks or losses of, another entity. If the Commission amends Commission Regulation 23.151, counterparties that trade with both prudentially regulated SDs and CFTC-regulated SDs may need to adjust their swap-related documentation and collateral management systems to reflect the different margin requirements that may apply under the CFTC's and the prudential regulators' rules. In that regard, the Commission requests information on the potential additional costs associated with maintaining two separate and distinct documentation and collateral management processes. How much weight should the Commission give with respect to the possible challenge that counterparties may need to maintain two separate and distinct documentation and collateral management systems? Should the Commission proceed to adopt the proposed amendments to Commission Regulation 23.151 if the prudential regulators do not adopt similar regulatory changes?

9. The Commission intends that the final rule will become effective 30 days after its publication in the Federal Register. With respect to the Seeded Funds Proposal, are there any comments on the effective date?

10. Does the existing asset transfer restriction significantly limit the use of money market and similar fund securities as eligible collateral under the CFTC Margin Rule?

11. Under the Money Market Funds Proposal, the securities of certain money market and similar funds that engage in repurchase or similar arrangements would qualify as eligible collateral. A money market and similar fund that engages in asset transfer transactions under a repurchase or similar arrangement may be exposed to increased risks, which may affect the liquidity and value of the fund's securities pledged as collateral under the CFTC Margin Rule. In light of the potential increased risk, should the Commission consider an alternative to the proposed rule amendment, such as

allowing the securities of money market and similar funds to qualify as eligible collateral only if a fund's repurchase or similar arrangements are cleared? Should the Commission impose any additional limits or conditions, such as restrictions on the type and terms of the repurchase or similar arrangements permitted for money market and similar funds for their shares to qualify as eligible collateral?

12. If the Commission eliminates the asset transfer restriction, should the Commission impose an additional haircut beyond that required by the haircut schedule in Commission Regulation 23.156(a)(3), as revised by the proposed amendment? If an additional haircut were to be adopted, what should the haircut be, and how should the haircut be calculated? Should such an additional haircut be proportionate to the net asset value of the assets of a money market and similar fund that are subject to repurchase or similar arrangements? Or instead, should the additional haircut be a fixed percentage similar to the percentages applicable to other assets that qualify as eligible collateral under the haircut schedule, as it may be less complex to administer? Should such additional fixed haircut apply to all securities of money market and similar funds that are used as eligible collateral or be applicable only to such securities of money market and similar funds that engage in repurchase or similar arrangements?

13. Given the potential impact that repurchase or similar agreements may have on the liquidity and value of securities of money market and similar funds that may be used as eligible collateral, should there be a percentage cap on the amount of assets that a fund can use for repurchase or similar arrangements, such as 10 percent of the total net asset value of the fund?

14. To gain a better understanding of the risks posed by repurchase and similar arrangements, the Commission requests information concerning the types of counterparties that typically face money market and similar funds in repurchase or similar agreements; the extent to which repurchase and similar arrangements are used by money market and similar funds; and whether the market treats differently money market and similar funds according to the types of repurchase and similar arrangements the funds enter into and the extent of repurchase agreements or arrangements the funds engage in. Further, the Commission requests comment with respect to the manner in which, and the extent to which, CSEs will meet their obligation to monitor the value and suitability of securities of money market and similar funds pledged as margin collateral where the funds engage in repurchase or similar arrangements.

15. Are the regulatory safeguards referenced in the Money Market Funds Proposal adequate to address the potential risks that may arise from the proposal? Are there other regulatory safeguards that the Commission should consider?

16. Are there any risks associated with the Money Market Funds Proposal that the Commission has not considered? In addition to the possible measures discussed above, including a possible additive haircut or a percentage cap on the amount of assets that funds could use in repurchase and similar agreements, are there other measures that the Commission could take to mitigate such risks?

17. The Prudential Regulators Margin Rule contains an equivalent asset transfer restriction. If the Commission amends Commission Regulation 23.156, counterparties that trade with both

prudentially regulated SDs and CFTC-regulated SDs may need to adjust their swap-related documentation and collateral management systems to reflect the different treatments for fund securities under the CFTC's and the prudential regulators' rules. In that regard, the Commission requests information on the potential additional costs associated with maintaining two separate and distinct documentation and collateral management processes. How much weight should the Commission give with respect to the possible challenge that counterparties may need to maintain two separate and distinct documentation and collateral management systems? Should the Commission proceed to adopt the proposed amendments to Commission Regulation 23.156 if the prudential regulators do not adopt similar regulatory changes?

18. The Commission intends that the final rule will become effective 30 days after its publication in the Federal Register. With respect to the Money Market Funds Proposal, are there any comments on the effective date?