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Managing Mandatory Margin: ISDA's 2016 Variation Margin Protocol

The International Swaps and Derivatives Association, Inc. ("ISDA") recently published the 2016 Variation Margin Protocol (the "VM Protocol")[1] to assist market participants in adapting to a new margin regime for uncleared derivatives that will come into effect on March 1, 2017. At the end of last year and earlier this year, the Department of the Treasury, the Federal Reserve System, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency (collectively, the "Prudential Regulators")[2] and the Commodity Futures Trading Commission (the "CFTC")[3] promulgated rules (the "Margin Rules") imposing minimum margin requirements on swap dealers, major swap participants and certain other regulated institutions (collectively, "Covered Swap Entities") in respect of their uncleared swaps and security-based swaps trading.[4] The VM Protocol provides market participants the tools to efficiently create new or amend existing credit support documentation to reflect the requirements of the Margin Rules. This Client Alert describes key features of the VM Protocol that will influence a market participant's decision regarding adherence and explains how to adhere.

I. What Does the VM Protocol Cover?

The VM Protocol is targeted at those Margin Rules that relate to variation margin with respect to uncleared derivatives trades between Covered Swap Entities and between Covered Swap Entities and their financial end-user counterparties (such as commodity pools and other financial institutions). In

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1 *See* ISDA's News Release of August 16, 2016 available at: http://www2.isda.org/news/isda-publishes-2016-variation-margin-protocol.

2 *See* Margin and Capital Requirements for Covered Swap Entities; Final Rule, 80 Fed. Reg. 229 (November 30, 2015), *available at* https://www.gpo.gov/fdsys/pkg/FR-2015-11-30/pdf/2015-28671.pdf.

3 *See* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants; Final Rule, 81 Fed. Reg. 3 (January 6, 2016), *available at* http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2015-32320-1a.pdf.

4 The Margin Rules promulgated by the Prudential Regulators govern "swaps" and "security-based swaps" (as defined in the Commodity Exchange Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and the rules promulgated thereunder), whereas the Margin Rules promulgated by the CFTC only apply to "swaps". For more information on the distinction between swaps and security-based swaps, please see https://www.paulweiss.com/practices/transactional/finance/publications/sec,-cftc-finalize-definition-of-swap,-security-based-swap,-security-based-swap-agreement-and-mixed-swap,-triggering-effectiveness-of-swap-regulations.aspx?id=10966.

particular, such rules impose (1) the obligation that Covered Swap Entities both collect and post variation margin, (2) the requirement that variation margin be exchanged subject to a zero threshold, (3) a $500,000 cap on minimum transfer amounts, (4) same-day/next-day margin transfer timing, (5) certain requirements regarding acceptable collateral and (6) specified haircuts for specific types of collateral. The VM Protocol offers market participants that are subject to the new regime a mechanism to update their credit support documentation with their counterparties to reflect these, and other, requirements of the Margin Rules.

II. Why Does the VM Protocol Only Cover Variation Margin?

Starting in 2011, the Basel Committee on Banking Supervision, the International Organization of Securities Commissions and other international regulators developed a framework for initial and variation margin requirements for uncleared derivatives, on which the Margin Rules are based. Under the Margin Rules, financial institutions in the U.S. with the largest uncleared derivatives portfolios commenced exchanging initial margin and variation margin on September 1, 2016. Initial margin requirements are scheduled to be phased in for other financial end-users with material swaps exposure over the next four years. The provisions regarding variation margin, however, are applicable to trading relationships between a Covered Swap Entity and any financial end-user starting on March 1, 2017, regardless of the size of the financial end-user's uncleared derivatives portfolio. The VM Protocol thus aims to provide market participants with the tools to comply with those Margin Rules expected to have the broadest and most immediate impact.

III. How Does the VM Protocol Work?

The VM Protocol adopts the now-familiar approach of the ISDA August 2012 DF Protocol and the ISDA March 2013 DF Protocol[5] – adhering parties submit an adherence letter on ISDA's website and provide more detailed information to counterparties via the exchange of questionnaires (either in paper form or online via Markit's ISDA Amend[6] utility).

The legal effect of the VM Protocol on adhering parties' credit support documentation will vary with the elections made by those parties. Specifically, adherents to the VM Protocol may choose to (1) amend any existing credit support annex ("CSA") to become compliant with the Margin Rules, (2) retain existing CSAs and enter into new CSAs based on the existing CSA (with changes necessary to satisfy the Margin

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5 For more information on the ISDA Dodd-Frank Protocols, please see https://www.paulweiss.com/practices/transactional/finance/publications/protocol-20-%E2%80%93-isda%E2%80%99s-march-2013-dodd-frank-protocol.aspx?id=13414.

6 The Markit ISDA Amend interface can be accessed at www.markit.com. As of the date of this Client Alert, the VM Protocol questionnaires are expected to become available for matching on ISDA Amend in October 2016.

Rules) or (3) enter into new CSAs based on ISDA's 2016 Credit Support Annex for Variation Margin (VM)[7]. By preserving an existing CSA, adherents are able to bifurcate their swaps portfolios with the effect that existing trades continue to be margined pursuant to the terms of their existing CSA, and new trades will be separately margined under the new CSA.

Other elections available to adhering parties include:

- Tailoring the scope of transactions subject to new and/or amended CSAs (i.e., <u>all</u> transactions executed under a relevant master agreement, regardless of whether those transactions are subject to the Margin Rules, or <u>only</u> those transactions subject to the Margin Rules)
- Sizing the minimum transfer amount
- Specifying assets that may be posted as credit support
- Setting the date on which new and/or amended CSAs become effective (no later than March 1, 2017)
- Specifying the latest notification time for same-day margin calls

IV. What Is the Timeline for Adherence?

There is no specific cut-off date for adhering to the VM Protocol (though ISDA retains the right to set such a date in the future). Practically speaking, the timing for adherence will be driven by the date on which the Margin Rules become applicable to specific counterparties – namely, March 1, 2017. Financial end-users should consider adhering in advance of this date to avoid trading disruptions.

V. How Do I Adhere?

As described above, adherence is a two-step process. Parties must first provide ISDA (via ISDA's website) with an adherence letter indicating their desire to adhere to the protocol; then, parties must complete a questionnaire (either in paper form or online via ISDA Amend), providing information about themselves, making certain elections and identifying the counterparties to whom they would like protocol-related information to be sent. In this context, it is possible for adhering parties to create different CSAs across separate designated counterparties. Note that the VM Protocol requires that the same entity who signed the documentation being amended submit the related adherence letter (e.g., if an investment manager is the original signatory, then that investment manager must adhere to the protocol on behalf of the entity for which it signed the documentation being amended).

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7 The 2016 Credit Support Annex for Variation Margin (VM) can be downloaded at the ISDA bookstore at the following link: http://www.isda.org/publications/isdacredit-users.aspx. Adherents should note that this document does <u>not</u> contain mechanics relating to initial margin and is meant to work alongside a CSA referencing only initial margin. Adherents who elect to enter into this form of CSA should consider whether an initial margin CSA is necessary to cover all economic terms pertinent to their trading relationships.

VI. Where Do I Obtain an Adherence Letter? Is There a Fee for Adhering?

Adherence letters may be obtained on ISDA's website at the following URL: https://www2.isda.org/functional-areas/protocol-management/submit-adherence-letter/. ISDA charges a $500 fee for the submission of each letter.

VII. Do I Need to Adhere?

Adherence is not mandatory. However, Covered Swap Entities are unlikely to enter into new transactions with financial end-users who have not brought their credit support documentation into compliance with the Margin Rules relating to variation margin by March 1, 2017, as they are subject to the mandatory margin requirements prescribed in the Margin Rules. For those market participants wishing to bring their credit support documentation into compliance, the VM Protocol offers a straightforward and comprehensive market-standard solution to ensure undisrupted trading.

That said, derivatives transactions of certain non-financial counterparties (such as corporate end-users) are not within the scope of the Margin Rules, and those market participants need not adhere or update their credit support documentation to comply with the Margin Rules. Similarly, financial end-users who trade only with non-Covered Swap Entities or who trade only exempt products such as physically-settled foreign exchange forwards or centrally cleared derivatives need not adhere or update their credit support documentation to comply with the Margin Rules. Parties who need to update their credit support documentation may also choose to forego adherence and execute individually negotiated amendments to their credit support documents instead.

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