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CFTC Proposes Changes to Margin Requirements for Uncleared Swaps

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On July 26, 2023, the CFTC approved a proposal to amend the margin regulations for uncleared swaps (the "*Proposed Amendments*").[1] The Proposed Amendments, if finalized, would relieve registered swap dealers and major swap participants ("*CFTC Registered Entities*") from the requirement to post and collect margin for uncleared swaps with certain eligible seeded funds for a limited time at the start of the life of the fund. The proposal would also allow for securities issued by certain pooled investment funds to be used as eligible collateral for regulatory margin requirements.

The CFTC has previously promulgated rules (the "*CFTC Uncleared Margin Rules*")[2] requiring CFTC Registered Entities for which there is no prudential regulator to post and collect initial margin for all swaps with certain specified swap counterparties that are not cleared by a registered clearinghouse. The CFTC Uncleared Margin Rules proscribe amounts of initial margin to be posted/collected, haircuts, thresholds for posting collateral and the types of margin that are eligible to be posted to comply with the initial margin requirements.

Seeded Fund Exclusion

CFTC Registered Entities are required to post and collect initial margin from "financial end users," entities whose business is financial in nature, with "material swaps exposure" of more than $8 billion. Material swaps exposure is calculated based on the average month-end aggregate notional amount of uncleared swaps for March, April and May of each year (the "*AANA*").[3] In performing the AANA calculation, a swap counterparty is required to include the AANA of any affiliate whose financials are consolidated with the financials of the swap counterparty (such entities, "*Margin Affiliates*"). The CFTC Uncleared Margin Rules allow for a $50 million threshold of credit exposure to the swap counterparty together with the exposure of its Margin Affiliates before initial margin needs to be posted or collected by a CFTC Registered Entity.

The Proposed Amendments would exclude certain seeded investment funds from the definition of Margin Affiliate for a period of three years from the date the fund begins making investments. This exclusion would apply to funds ("*Seeded Funds*") that meet certain requirements, including:

(i) the fund is a distinct legal entity from its sponsors;

(ii) the fund has one or more Margin Affiliates that are subject to the initial margin requirements under the CFTC Uncleared Margin Rules;

(iii) the fund is managed by an asset manager pursuant to an agreement that requires the manager to adhere to a specific written investment strategy;

(iv) the fund's asset manager has independence in carrying out its management responsibilities and has investment discretion;

(v) the fund has a written plan for reducing the sponsor's ownership in the fund over the three-year period after the manager begins making investments;

(vi) the fund is not guaranteed or otherwise supported (directly or indirectly) by the sponsor, any Margin Affiliate or the asset manager;

(vii) the fund has not received any assets from a Seeded Fund that relied on this exclusion; and

(viii) the fund is not a securitization vehicle.

As a result of this proposed exclusion, CFTC Registered Entities would not be required to post or collect initial margin from most Seeded Funds since these funds, by themselves, generally do not engage in a level of swap activity resulting in material swaps exposure. This limited exception to the requirement to post and collect initial margin is intended to provide much needed relief to Seeded Funds from the drag on performance caused by tying up a large portion of their investments in posting initial margin for their uncleared swaps. Market participants noted to the CFTC that this performance drag is also a disincentive to attracting unaffiliated investors to Seeded Funds. The CFTC notes that the three-year term of this proposed exclusion is intended to allow the Seeded Funds time to work towards establishing a performance track-record and attracting unaffiliated investors.

The swaps exposure of Seeded Funds will continue to be included in the AANA calculation of its Margin Affiliates in determining whether its Margin Affiliates have material swaps exposure and are required to post and collect initial margin. Additionally, the Proposed Amendments do not relieve CFTC Registered Entities from requirements to post and collect variation margin from Seeded Funds.

Money Market Funds

The CFTC Uncleared Margin Rules allow parties to post securities of money market and similar funds ("*Money Market Funds*") as eligible collateral if certain criteria are met.[4] To qualify, the investments of the fund must be limited to Treasury securities, securities issued or fully guaranteed by the European Central Bank, certain other securities issued by sovereign entities and immediately available cash in the same currencies. Additionally, the asset managers of the funds may not transfer any of these assets through any repurchase or securities lending agreements. This restriction on the transfer of assets has effectively disqualified most Money Market Funds from qualifying as eligible collateral for uncleared swaps as most eligible funds use repurchase or securities lending and similar investments as part of their management strategy.

The Proposed Amendments would remove the restriction on transferring assets through repurchase or securities lending agreements, allowing for a broader range of Money Market Funds to qualify as eligible collateral with respect to margin for uncleared swaps. The CFTC recognizes that Money Market Funds are safe, high quality investments and, in fact, currently allows for futures commission merchants to invest margin held by the futures commission merchant in Money Market Funds. This change will also more closely align with the SEC's regulations which allow for Money Market Funds to be used as collateral, even if the fund engages in repurchase, securities lending or other similar transactions. The CFTC hopes that expanding the use of Money Market Funds as collateral will lead to more efficient collateral management.

The comment period for the Proposed Amendments will remain open until October 10, 2023.

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[1] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 88 Fed. Reg. 53409 (August 8, 2023).

[2] *See generally* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 636 (Jan. 6, 2016), 17 C.F.R. Parts 23.150 through 23.161.

[3] 17 C.F.R. 23.161.

[4] 17 C.F.R. 23.156.

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