DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

12 CFR Part 45

[Docket No. OCC–2011–0008]

RIN 1557–AD43

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

12 CFR Part 237

[Docket No. R–1415]

RIN 7100 AD74

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Part 324

RIN 3064–AD79

FARM CREDIT ADMINISTRATION

12 CFR Part 624

RIN 3052–AC69

FEDERAL HOUSING FINANCE AGENCY

12 CFR Part 1221

RIN 2590–AA45

Margin and Capital Requirements for Covered Swap Entities

AGENCY: Office of the Comptroller of the Currency, Treasury (OCC); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); Farm Credit Administration (FCA); and the Federal Housing Finance Agency (FHFA).

ACTION: Notice of proposed rulemaking.

SUMMARY: The OCC, Board, FDIC, FCA, and FHFA (collectively, the Agencies) are requesting comment on a proposal to establish minimum margin and capital requirements for registered swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants for which one of the Agencies is the prudential regulator. This proposed rule implements sections 731 and 764 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which require the Agencies to adopt rules jointly to establish capital requirements and initial and variation margin requirements for such entities on all non-cleared swaps and non-cleared security-based swaps in order to offset the greater risk to such entities and the financial system arising from the use of swaps and security-based swaps that are not cleared.

DATES: Comments should be received on or before June 24, 2011.

ADDRESSES: Interested parties are encouraged to submit written comments jointly to all of the Agencies. Commenters are encouraged to use the title "Margin and Capital Requirements for Covered Swap Entities" to facilitate the organization and distribution of comments among the Agencies. Commenters are also encouraged to identify the number of the specific question for comment to which they are responding.

Office of the Comptroller of the Currency: Because paper mail in the Washington, DC area and at the OCC is subject to delay, commenters are encouraged to submit comments by the Federal eRulemaking Portal or e-mail, if possible. Please use the title "Margin and Capital Requirements" to facilitate the organization and distribution of the comments. You may submit comments by any of the following methods:

- *Federal eRulemaking Portal—"Regulations.gov":* Go to *http://www.regulations.gov.* Select "Document Type" of "Proposed Rules," and in the "Enter Keyword or ID Box," enter Docket ID "OCC–2011–0008," and click "Search." On "View By Relevance" tab at the bottom of screen, in the "Agency" column, locate the Proposed Rule for the OCC, in the "Action" column, click on "Submit a Comment" or "Open Docket Folder" to submit or view public comments and to view supporting and related materials for this rulemaking action.
- Click on the "Help" tab on the Regulations.gov home page to get information on using Regulations.gov, including instructions for submitting or viewing public comments, viewing other supporting and related materials, and viewing the docket after the close of the comment period.
- *E-mail: regs.comments@occ.treas.gov.*
- *Mail:* Office of the Comptroller of the Currency, 250 E Street, SW., Mail Stop 2–3, Washington, DC 20219.
- *Fax:* (202) 874–5274.
- *Hand Delivery/Courier:* 250 E Street, SW., Mail Stop 2–3, Washington, DC 20219.

Instructions: You must include "OCC" as the agency name and "Docket ID OCC–2011–0008" in your comment. In general, OCC will enter all comments received into the docket and publish them on the Regulations.gov Web site without change, including any business or personal information that you provide such as name and address information, e-mail addresses, or phone numbers. Comments received, including attachments and other supporting materials, are part of the public record and subject to public disclosure. Do not enclose any information in your comment or supporting materials that you consider confidential or inappropriate for public disclosure.

You may review comments and other related materials that pertain to this proposed rulemaking by any of the following methods:

- *Viewing Comments Electronically:* Go to *http://www.regulations.gov.* Select "Document Type" of "Public Submissions," and in the "Enter Keyword or ID Box," enter Docket ID "OCC–2011–0008," and click "Search." Comments will be listed under "View By Relevance" tab at the bottom of screen. If comments from more than one agency are listed, the "Agency" column will indicate which comments were received by the OCC.
- *Viewing Comments Personally:* You may personally inspect and photocopy comments at the OCC, 250 E Street, SW., Washington, DC. For security reasons, the OCC requires that visitors make an appointment to inspect comments. You may do so by calling (202) 874–4700. Upon arrival, visitors will be required to present valid government-issued photo identification and submit to security screening in order to inspect and photocopy comments.
- *Docket:* You may also view or request available background documents and project summaries using the methods described above.

Board of Governors of the Federal Reserve System

You may submit comments, identified by Docket No. R–1415 and RIN 7100 AD74, by any of the following methods:

- *Agency Web Site: http://www.federalreserve.gov.* Follow the instructions for submitting comments at *http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm.*
- *Federal eRulemaking Portal: http://www.regulations.gov.* Follow the instructions for submitting comments.
- *E-mail: regs.comments@federalreserve.gov.* Include the docket number in the subject line of the message.
- *Fax:* (202) 452–3819 or (202) 452–3102.
- *Mail:* Address to Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551.

All public comments will be made available on the Board's Web site at *http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm* as submitted, unless modified for technical reasons. Accordingly, comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper in Room MP–500 of the Board's Martin Building (20th and C Streets, NW.) between 9 a.m. and 5 p.m. on weekdays.

Federal Deposit Insurance Corporation: You may submit comments, identified by RIN number, by any of the following methods:

• *Agency Web Site: http://www.fdic.gov/regulations/laws/federal/propose.html.* Follow instructions for submitting comments on the Agency Web site.

• *E-mail: Comments@FDIC.gov.* Include the RIN number on the subject line of the message.

• *Mail:* Robert E. Feldman, Executive Secretary, Attention: Comments, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.

• *Hand Delivery:* Comments may be hand delivered to the guard station at the rear of the 550 17th Street Building (located on F Street) on business days between 7 a.m. and 5 p.m.

Instructions: All comments received must include the agency name and RIN for this rulemaking and will be posted without change to *http://www.fdic.gov/regulations/laws/federal/propose.html,* including any personal information provided.

Federal Housing Finance Agency: You may submit your written comments on the proposed rulemaking, identified by regulatory information number (RIN) 2590–AA45, by any of the following methods:

• *E-mail:* Comments to Alfred M. Pollard, General Counsel, may be sent by e-mail at *RegComments@fhfa.gov.* Please include "RIN 2590–AA45" in the subject line of the message.

• *Federal eRulemaking Portal: http://www.regulations.gov.* Follow the instructions for submitting comments. If you submit your comment to the Federal eRulemaking Portal, please also send it by e-mail to FHFA at *RegComments@fhfa.gov* to ensure timely receipt by the Agency. Please include "RIN 2590–AA45" in the subject line of the message.

• *U.S. Mail, United Parcel Service, Federal Express, or Other Mail Service:* The mailing address for comments is: Alfred M. Pollard, General Counsel, Attention: Comments/RIN 2590–AA45, Federal Housing Finance Agency, Fourth Floor, 1700 G Street, NW., Washington, DC 20552.

• *Hand Delivery/Courier:* The hand delivery address is: Alfred M. Pollard, General Counsel, Attention: Comments/RIN 2590–AA45, Federal Housing Finance Agency, Fourth Floor, 1700 G Street, NW., Washington, DC 20552. A hand-delivered package should be logged at the Guard Desk, First Floor, on business days between 9 a.m. and 5 p.m.

All comments received by the deadline will be posted for public inspection without change, including any personal information you provide, such as your name and address, on the FHFA Web site at *http://www.fhfa.gov.* Copies of all comments timely received will be available for public inspection and copying at the address above on government-business days between the hours of 10 a.m. and 3 p.m. To make an appointment to inspect comments please call the Office of General Counsel at (202) 414–6924.

Farm Credit Administration: We offer a variety of methods for you to submit your comments. For accuracy and efficiency reasons, commenters are encouraged to submit comments by e-mail or through the FCA's Web site. As facsimiles (fax) are difficult for us to process and achieve compliance with section 508 of the Rehabilitation Act, we are no longer accepting comments submitted by fax. Regardless of the method you use, please do not submit your comments multiple times via different methods. You may submit comments by any of the following methods:

• *E-mail:* Send us an e-mail at *reg-comm@fca.gov.*

• *FCA Web site: http://www.fca.gov.* Select "Public Commenters," then "Public Comments," and follow the directions for "Submitting a Comment."

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

• *Mail:* Gary K. Van Meter, Acting Director, Office of Regulatory Policy, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102–5090.

You may review copies of all comments we receive at our office in McLean, Virginia or on our Web site at *http://www.fca.gov.* Once you are in the Web site, select "Public Commenters," then "Public Comments," and follow the directions for "Reading Submitted Public Comments." We will show your comments as submitted, including any supporting data provided, but for technical reasons we may omit items such as logos and special characters. Identifying information that you provide, such as phone numbers and addresses, will be publicly available. However, we will attempt to remove e-mail addresses to help reduce Internet spam.

FOR FURTHER INFORMATION CONTACT:

OCC: Michael Sullivan, Market RAD (202) 874–3978, Kurt Wilhelm, Director, Financial Markets Group (202) 874–4479, Jamey Basham, Assistant Director, Legislative and Regulatory Activities Division (202) 874–5090, or Ron Shimabukuro, Senior Counsel, Legislative and Regulatory Activities Division (202) 874–5090, Office of the Comptroller of the Currency, 250 E Street, SW., Washington, DC 20219.

Board: Sean D. Campbell, Deputy Associate Director, Division of Research and Statistics, (202) 452–3761, Michael Gibson, Senior Associate Director, Division of Research and Statistics, (202) 452–2495, or Jeremy R. Newell, Senior Attorney, Legal Division, (202) 452–3239, Board of Governors of the Federal Reserve System, 20th and C Streets, NW., Washington, DC 20551.

FDIC: Bobby R. Bean, Chief, Policy Section, (202) 898–6705, John Feid, Senior Capital Markets Specialist, (202) 898–8649, Division of Risk Management Supervision, Thomas F. Hearn, Counsel, (202) 898–6967, or Ryan K. Clougherty, Senior Attorney, (202) 898–3843, Legal Division, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.

FHFA: Robert Collender, Principal Policy Analyst, Office of Policy Analysis and Research, (202) 343–1510, *Robert.Collender@fhfa.gov,* Peggy Balsawer, Assistant General Counsel, Office of General Counsel, (202) 343–1529, *Peggy.Balsawer@fhfa.gov.* or James Carley, Senior Associate Director, Division of FHLBank Regulation, (202) 408–2507, *James.Carley@fhfa.gov,* Federal Housing Finance Agency, Fourth Floor, 1700 G Street, NW., Washington, DC 20552. The telephone number for the Telecommunications Device for the Hearing Impaired is (800) 877–8339.

FCA: William G. Dunn, Acting Associate Director, Finance and Capital Markets Team, Office of Regulatory Policy, Farm Credit Administration, McLean, VA 22102–5090, (703) 883–4414, TTY (703) 883–4434, Joseph T. Connor, Associate Director for Policy and Analysis, Office of Secondary Market Oversight, Farm Credit Administration, McLean, VA 22102–5090, (703) 883–4280, TTY (703) 883–4434, or Rebecca S. Orlich, Senior Counsel, Office of General Counsel, Farm Credit Administration, McLean, VA 22102–5090, (703) 883–4020, TTY (703) 883–4020.

SUPPLEMENTARY INFORMATION:

I. Background

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) was enacted on July 21, 2010.[1] Title VII of the Dodd-Frank Act established a comprehensive new regulatory framework for derivatives, which the Act generally characterizes as "swaps" (which are defined in section 721 of the Dodd-Frank Act to include interest rate swaps, commodity-based swaps, and broad-based credit swaps) and "security-based swaps" (which are defined in section 761 of the Dodd-Frank Act to include single-name and narrow-based credit swaps and equity-based swaps).[2]

As part of this new regulatory framework, sections 731 and 764 of the Dodd-Frank Act add a new section 4s to the Commodity Exchange Act and a new section 15F to the Securities Exchange Act of 1934, respectively, which require the registration and regulation of swap dealers and major swap participants and security-based swap dealers and major security-based swap participants (collectively, swap entities).[3] For certain types of swap entities that are prudentially regulated by one of the Agencies,[4] sections 731 and 764 of the Dodd-Frank Act require the Agencies to adopt rules jointly for swap entities under their respective jurisdictions imposing (i) capital requirements and (ii) initial and variation margin requirements on all non-cleared swaps and non-cleared security-based swaps.[5] Swap entities that are prudentially regulated by the Agencies and therefore subject to the proposed rule are referred to herein as "covered swap entities."

Sections 731 and 764 of the Dodd-Frank Act require the CFTC and SEC to separately adopt rules imposing capital and margin requirements for swap entities for which there is no prudential regulator.[6] The Dodd-Frank Act requires the CFTC, SEC, and the Agencies to establish and maintain, to the maximum extent practicable, capital and margin requirements that are comparable, and to consult with each other periodically (but no less than annually) regarding these requirements.[7]

The capital and margin standards for swap entities imposed under sections 731 and 764 of the Dodd-Frank Act are intended to offset the greater risk to the swap entity and the financial system arising from the use of swaps and security-based swaps that are not cleared.[8] Sections 731 and 764 of the Dodd-Frank Act require that the capital and margin requirements imposed on swap entities must, to offset such risk, (i) help ensure the safety and soundness of the swap entity and (ii) be appropriate for the greater risk associated with the non-cleared swaps and non-cleared security-based swaps held as a swap entity.[9] In addition, Sections 731 and 764 of the Dodd-Frank Act require the Agencies, in establishing capital rules for covered swap entities, to take into account the risks associated with other types, classes or categories of swaps or security-based swaps engaged in, and the other activities conducted by that person that are not otherwise subject to regulation applicable to that person by virtue of the status of the person as a swap dealer or a major swap participant.[10] Sections 731 and 764 become effective not less than 60 days after publication of the final rule or regulation implementing these sections.[11]

The capital and margin requirements that must be established with respect to

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[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (2010).

[2] *See* 7 U.S.C. 1a(47); 15 U.S.C. 78c(a)(68). Swaps and security-based swaps are sometimes referred to herein collectively as "derivatives."

[3] *See* 7 U.S.C. 6s; 15 U.S.C. 78*o*–8. Section 731 of the Dodd-Frank Act requires swap dealers and major swap participants to register with the Commodity Futures Trading Commission (the "CFTC"), which is vested with primary responsibility for the oversight of the swaps market under title 7 of the Dodd Frank Act. Section 764 of the Dodd-Frank Act requires security-based swap dealers and major security-based swap participants to register with the Securities and Exchange Commission (the "SEC"), which is vested with primary responsibility for the oversight of the security-based swaps market under title 7 of the Dodd-Frank Act. Section 713(d)(1) of the Dodd-Frank Act requires the CFTC and SEC to issue joint rules further defining the terms swap dealer, major swap participant, security-based swap dealer, and major security-based swap participant. The CFTC and SEC issued a joint notice of proposed rulemaking with respect to these definitions in December, 2010. *See* 75 FR 80,174 (Dec. 21, 2010) (proposed rule).

[4] Section 1a(39) of the Commodities Exchange Act defines the term "prudential regulator" for purposes of the capital and margin requirements applicable to swap dealers, major swap participants, security-based swap dealers and major security-based swap participants. The Board is the prudential regulator for any swap entity that is (i) a State-chartered bank that is a member of the Federal Reserve System, (ii) a State-chartered branch or agency of a foreign bank, (iii) a foreign bank which does not operate an insured branch, (iv) an organization operating under section 25A of the Federal Reserve Act (an Edge corporation) or having an agreement with the Board under section 25 of the Federal Reserve Act (an Agreement corporation), and (v) a bank holding company, a foreign bank that is treated as a bank holding company under section 8(a) of the International Banking Act of 1978, or a savings and loan holding company (on or after the transfer date established under section 311 of the Dodd-Frank Act), or a subsidiary of such a company or foreign bank (other than a subsidiary for which the OCC or FDIC is the prudential regulator or that is required to be registered with the CFTC or SEC as a swap dealer or major swap participant or a security-based swap dealer or major security-based swap participant, respectively). The OCC is the prudential regulator for any swap entity that is a national bank, a Federally chartered branch or agency of a foreign bank, or a Federal savings association. The FDIC is the prudential regulator for any swap entity that is (i) a State-chartered bank that is not a member of the Federal Reserve System or (ii) a State savings association. The FCA is the prudential regulator for any swap entity that is an institution chartered under the Farm Credit Act of 1971, as amended. FHFA is the prudential regulator for any swap entity that is a "regulated entity" under the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (*i.e.*, the Federal National Mortgage Association and its affiliates, the Federal Home Loan Mortgage Corporation and its affiliates, and the Federal Home Loan Banks). *See* 7 U.S.C. 1a(39).

[5] *See* 7 U.S.C. 6s(e)(2)(A); 15 U.S.C. 78*o*–8(e)(2)(A). Section 6(s)(e)(1)(A) directs registered swap dealers and major swap participants for which there is a prudential regulator to comply with margin and capital rules issued by the prudential regulators, while section 6(s)(e)(1)(B) directs registered swap dealers and major swap participants for which there is not a prudential regulator to comply with margin and capital rules issued by the CFTC and SEC. Section 78o–8(e)(1) generally parallels section 6s(e)(1), except that section 78o–8(e)(1)(A) refers to registered security-based swap dealers and major security-based swap participants for which "there is not a prudential regulator." The Agencies construe the "not" in section 78o–8(e)(1)(A) to have been included by mistake, in conflict with section 78*o*–8(e)(2)(A), and of no substantive meaning. Otherwise, registered security-based swap dealers and major security-based swap participants for which there is not a prudential regulator could be subject to multiple capital and margin rules, and institutions regulated by the prudential regulators and registered as security-based swap dealers and major security-based swap participants might not be subject to any capital and margin requirements under section 78*o*–8(e).

[6] *See* 7 U.S.C. 6s(e)(2)(B); 15 U.S.C. 78*o*–8(e)(2)(B).

[7] *See* 7 U.S.C. 6s(e)(2)(A); 6s(e)(3)(D); 15 U.S.C. 78*o*–8(e)(2)(A), 78*o*–8(e)(3)(D). Staff of the Agencies have consulted with staff of the CFTC and SEC in developing the proposed rule.

[8] *See* 7 U.S.C. 6s(e)(3)(A); 15 U.S.C. 78*o*–8(e)(3)(A).

[9] *See* 7 U.S.C. 6s(e)(3)(A); 15 U.S.C. 78*o*–8(e)(3)(A). In addition, Section 1201 of Housing and Economic Recovery Act of 2008 (Pub. L. 110–289, 122 Stat. 2654) requires the Director of FHFA, when promulgating regulations relating to the Federal Home Loan Banks, to consider the following differences between the Federal Home Loan Banks and the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac): cooperative ownership structure; mission of providing liquidity to members; affordable housing and community development mission; capital structure; and joint and several liability. *See* section 1201 Public Law 110–289, 122 Stat. 2782–83 (amending 12 U.S.C. 4513). The Director of FHFA also may consider any other differences that are deemed appropriate. For purposes of this proposed rule, FHFA considered the differences as they relate to the above factors. FHFA requests comments from the public about whether differences related to these factors should result in any revisions to the proposal.

[10] *See* 7 U.S.C. 6s(e)(2)(C); 15 U.S.C. 78*o*–8(e)(2)(C). In addition, the margin requirements imposed by the Agencies must permit the use of noncash collateral, as the Agencies determine to be consistent with (i) preserving the financial integrity of the markets trading swaps and security-based swaps and (ii) preserving the stability of the U.S. financial system. *See* 7 U.S.C. 6s(e)(3)(C); 15 U.S.C. 78*o*–8(e)(3)(C).

[11] *See* Dodd Frank Act §§ 754, 774.

non-cleared derivatives under sections 731 and 764 of the Dodd-Frank Act complement changes made elsewhere in the Act that require all sufficiently standardized swaps and security-based swaps be cleared through a derivatives clearing organization or clearing agency.[12] This clearing mandate reflects the consensus of the G–20 leaders: "All standardized over-the-counter derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end of 2012 at the latest."[13]

In the derivatives clearing process, central counterparties (CCPs) manage the credit risk through a range of controls and methods, including a margining regime that imposes both initial margin and variation margin requirements on parties to cleared transactions.[14] Thus, the mandatory clearing requirement established by the Dodd-Frank Act for swaps and security-based swaps will effectively require any party to any transaction subject to the clearing mandate to post initial and variation margin to the CCP in connection with that transaction.

However, if a particular swap or security-based swap is not cleared because it is not subject to the mandatory clearing requirement (or because one of the parties to a particular swap or security-based swap is eligible for, and uses, an exemption from the mandatory clearing requirement), that swap or security-based swap will be a "non-cleared" swap or security-based swap and will be subject to the capital and margin requirements for such transactions established under sections 731 and 764 of the Dodd-Frank Act.

The comprehensive derivatives-related provisions of title VII of the Dodd-Frank Act, including sections 731 and 764, are intended in general to reduce risk, increase transparency, promote market integrity within the financial system, and, in particular, address a number of weaknesses in the regulation and structure of the derivatives markets that were revealed during the financial crisis experienced in 2008 and 2009. During the financial crisis, the opacity of derivatives transactions among dealer banks and between dealer banks and their counterparties created uncertainty about whether market participants were significantly exposed to the risk of a default by a swap counterparty. By imposing a regulatory margin requirement on non-cleared swaps, the Dodd-Frank Act will reduce the uncertainty around the possible exposures arising from non-cleared swaps.

The recent financial crisis also revealed that some participants in the derivatives markets had used derivatives to take on excessive risks. By imposing a minimum margin requirement on non-cleared derivatives, sections 731 and 764 of the Dodd-Frank Act will reduce the ability of firms to take on excessive risks through swaps without sufficient financial resources to make good on their contracts. Because the Dodd-Frank Act requires that the margin requirements be based on the risks posed by the non-cleared derivatives and derivatives counterparties, firms that take significant risks through derivatives will face more stringent margin requirements with respect to non-cleared derivatives, while firms that take lower risks will face less stringent margin requirements.

II. Overview of Proposed Rule

A. Margin Requirements

The Agencies have generally adopted a risk-based approach in proposing rules to establish initial and variation margin requirements for covered swap entities, consistent with the statutory requirement that these rules help ensure the safety and soundness of the covered swap entity and be appropriate for the risk to the financial system associated with non-cleared swaps and non-cleared security-based swaps held by covered swap entities. As a result, the proposed rule takes into account the relative risk of a covered swap entity's activities in establishing both (i) the minimum amount of initial and variation margin that it must collect from its counterparties and (ii) the frequency with which a covered swap entity must calculate and collect variation margin from its counterparty.

In implementing this risk-based approach, the proposed rule distinguishes among four separate types of derivatives counterparties: (i) Counterparties that are themselves swap entities; (ii) counterparties that are high-risk financial end users of derivatives; (iii) counterparties that are low-risk financial end users of derivatives; and (iv) counterparties that are nonfinancial end users of derivatives.[15] These categories reflect the Agencies' preliminary belief that distinctions can be made between types of derivatives counterparties that are useful in distinguishing the risks posed by each type.

The proposed rule's initial and variation margin requirements generally apply only to the *collection* of minimum margin amounts by a covered swap entity from its counterparties; they do not contain specific requirements as to the amount of initial or variation margin that a covered swap entity must *post* to its counterparties.[16] This approach, which emphasizes the collection rather than the posting of margin, is based primarily on the Agencies' preliminary view that imposing requirements with respect to the minimum amount of margin to be collected (but not posted) is a critical aspect of offsetting the greater risk to the covered swap entity and the financial system arising from the covered swap entity's holdings of swaps and security-based swaps that are not cleared and helps ensure the safety and soundness of the covered swap entity. The proposed rule's approach would also assure that swap entities transacting with one another will effectively be collecting and posting margin with respect to those transactions as a result of the margin collection requirements imposed on each.

With respect to initial margin, the proposed rule permits a covered swap entity to select from two alternatives to calculate its initial margin requirements. A covered swap entity may calculate its initial margin requirements using a standardized "lookup" table that

[12] *See* 7 U.S.C. 2(h); 15 U.S.C. 78c–3. Certain types of counterparties (*e.g.,* counterparties that are not financial entities and are using swaps or security-based swaps to hedge or mitigate commercial risks) are exempt from this mandatory clearing requirement and may elect not to clear a swap or security-based swap that would otherwise be subject to the clearing requirement.

[13] G–20 Leaders, June 2010 Toronto Summit Declaration, ¶ 25. The dealer community has also recognized the importance of clearing—beginning in 2009, in an effort led by the Federal Reserve Bank of New York, the dealer community agreed to increase central clearing for certain credit derivatives and interest rate derivatives. *See* Press Release, Federal Reserve Bank of New York, New York Fed Welcomes Further Industry Commitments on Over-the-Counter Derivatives press release (June 2, 2009), *available at http://www.newyorkfed.org/newsevents/news/markets/2009/ma090602.html.*

[14] CCPs interpose themselves between counterparties to a derivative transaction, becoming the buyer to the seller and the seller to the buyer and, in the process, taking on the credit risk that each party poses to the other. For example, when a derivatives contract between two parties that are members of a CCP is executed and submitted for clearing, it is typically replaced by two new contracts—separate contracts between the CCP and each of the two original counterparties. At that point, the original counterparties are no longer counterparties to each other; instead, each faces the CCP as its counterparty, and the CCP assumes the counterparty credit risk of each of the original counterparties.

[15] See proposed rule §§ __.2(b), (g), (h), (i), (n), (r) and (y) for the various constituent definitions that identify these four types of swap counterparties.

[16] Section __.11 of the proposed rule adopted by FHFA and FCA (but not the other Agencies) requires that their regulated entities collect initial and variation margin from swap entities, as described in section III.K of this notice.

specifies the minimum initial margin that must be collected, expressed as a percentage of the notional amount of the swap or security-based swap. These percentages depend on the broad asset class of the swap or security-based swap.[17] Alternatively, a covered swap entity may calculate its minimum initial margin requirements using an internal margin model that meets certain criteria and that has been approved by the relevant prudential regulator.[18]

A covered swap entity adopting the first alternative generally must collect at least the amount of initial margin required under the standardized look-up table, regardless of the relative risk of its counterparty. A covered swap entity adopting the second alternative generally must collect at least the amount of initial margin required under its initial margin model. Both alternatives permit a covered swap entity to adopt a threshold amount below which it need not collect initial margin from certain types of counterparties.[19] Under the proposed rule, the maximum threshold amount permitted varies based on the relative risk posed by the counterparty, as determined by counterparty type.

With respect to variation margin, the proposed rule generally requires a covered swap entity to collect variation margin periodically in an amount that is at least equal to the increase in the value of the swap to the covered swap entity.[20] As with initial margin, a covered swap entity may adopt a threshold amount below which it need not collect variation margin from certain types of lower-risk counterparties.[21] Consistent with the approach taken to initial margin, the maximum threshold amount permitted for variation margin varies based on the relative risk of the counterparty, as determined by counterparty type. In addition, the frequency with which a covered swap entity must periodically recalculate and collect variation margin under the proposed rule also varies based on the relative risk of the counterparty, as determined by counterparty type, and generally decreases as the relative risk of the counterparty type decreases.[22]

The proposed rule's margin provisions establish only *minimum* requirements with respect to initial margin and variation that must be collected. Nothing in the proposed rule is intended to prevent or discourage a covered swap entity from collecting margin in amounts greater than is required under the proposed rule.

The proposed rule also specifies the types of collateral that are eligible to be collected to satisfy both the initial and variation margin requirements. Eligible collateral is generally limited to (i) immediately available cash funds and (ii) certain high-quality, highly-liquid U.S. government and agency obligations and, in the case of initial margin only, certain government-sponsored enterprise obligations, subject to specified minimum "haircuts" for purposes of determining their value for margin purposes.[23]

Separate from the proposed rule's requirements with respect to the collection of initial and variation margin, the proposed rule also requires a covered swap entity to ensure that its counterparty segregates the initial margin that the covered swap entity *posts* when engaging in swap or security-based swap transactions with another swap entity.[24] The Agencies have proposed a requirement that segregation of initial margin be mandatory, not optional, for swap transactions by a covered swap entity with another swap entity in order to (i) offset the greater risk to the covered swap entity and the financial system arising from the use of swaps and security-based swaps that are not cleared and (ii) protect the safety and soundness of the covered swap entity.

B. Capital Requirements

Sections 731 and 764 of the Dodd-Frank Act also require the Agencies to issue, in addition to margin rules, joint rules on capital for covered swap entities for which they are the prudential regulator.[25] The Board, FDIC, and OCC (collectively, the banking agencies) have had risk-based capital rules in place for banks to address over-the-counter derivatives since 1989 when the banking agencies implemented their risk-based capital adequacy standards (general banking risk-based capital rules)[26] based on the first Basel Accord.[27] The general banking risk-based capital rules have been amended and supplemented over time to take into account developments in the derivatives market. These supplements include the addition of the market risk amendment to the first Basel Accord which requires banks and bank holding companies meeting certain thresholds to calculate their capital requirements for trading positions through models approved by their primary Federal supervisor.[28] In addition, certain large, complex banks and bank holding companies are subject to the banking agencies' advanced risk-based capital standards (advanced approaches rules), based on the advanced approaches of the Basel II Accord.[29]

FHFA's predecessor agencies used a similar methodology to frame the risk-based capital rules applicable to those entities now regulated by FHFA. The FCA's risk-based capital regulations for Farm Credit System institutions, except for the Federal Agricultural Mortgage Corporation (Farmer Mac), have been in place since 1988 and were updated in 2005.[30] The FCA's risk-based capital regulations for Farmer Mac have been in place since 2001 and were updated in 2006.[31]

The Basel Committee on Banking Supervision has recently revised and enhanced its capital framework for internationally active banks,[32] and the banking agencies expect to propose these changes in the United States in the near future through a separate notice of proposed rulemaking.

As described in section III.J below, the proposed rule requires a covered swap entity to comply with regulatory capital

[17] *See* proposed rule, Appendix A.

[18] *See* proposed rule §§ __.2(*l*), __.3(a), __.8.

[19] *See* proposed rule §§ __.2(m), __.3(a)(2).

[20] *See* proposed rule §§ __.2(z), __.4(a).

[21] *See* proposed rule §§ __.2(bb), __.4(a)(2).

[22] *See* proposed rule § __.4(b).

[23] *See* proposed rule § __.6.

[24] *See* proposed rule § __.7. The Agencies note that sections 724 and 763 of Dodd-Frank Act require a swap entity to offer its swap and security-based swap counterparties the option of requiring segregation of initial margin they post to the swap entity.

[25] 7 U.S.C. 6s(e)(2); 15 U.S.C. 78*o*–8(e)(2).

[26] *See* 54 FR 4186 (January 27, 1989). The general banking risk-based capital rules are codified at 12 CFR part 3, Appendix A (OCC); 12 CFR parts 208 and 225, Appendix A (Board); and 12 CFR part 325, Appendix A (FDIC).

[27] The Basel Committee on Banking Supervision (BCBS) developed the first international banking capital framework in 1988, entitled *International Convergence of Capital Measurement and Capital Standards.*

[28] 61 FR 47358 (September 6, 1996). The banking agencies' market risk capital rules are at 12 CFR part 3, Appendix B (OCC); 12 CFR part 208, Appendix E and 12 CFR part 225, Appendix E (Board); and 12 CFR part 325, Appendix C (FDIC). The rules apply to banks and bank holding companies with trading activity (on a worldwide consolidated basis) that equals 10 percent or more of the institution's total assets, or $1 billion or more.

[29] *See* BCBS, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework* (2006). The banking agencies implemented the advanced approaches of the Basel II Accord in 2007. *See* 72 FR 69288 (December 7, 2010). The advanced approaches rules are codified at 12 CFR part 3, Appendix C (OCC); 12 CFR part 208, Appendix F and 12 CFR part 225, Appendix G (Board); and 12 CFR part 325, Appendix D (FDIC).

[30] *See* 53 FR 40.033 (Oct. 13, 1988); 70 FR 35.336 (June 17, 2005); 12 CFR part 615 subpart H.

[31] *See* 66 FR 19,048 (April 12, 2001); 71 FR 77,247 (Dec. 26, 2006); 12 CFR part 652.

[32] *See* BCBS, *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* (2010), *available at http://www.bis.org/publ.bcbs189.htm.*

rules already made applicable to that covered swap entity as part of its prudential regulatory regime. As discussed further below, given that these existing regulatory capital rules already specifically take into account and address the unique risks arising from derivatives transactions and activities, the Agencies are proposing to rely on these existing rules, subject to the future notice of proposed rulemaking described above, as appropriate and sufficient to offset the greater risk to the covered swap entity and the financial system arising from the use of swaps and security-based swaps that are not cleared and to protect the safety and soundness of the covered swap entity.[33]

III. Section-by-Section Summary of Proposed Rule

A. Section __.1: Authority, Purpose and Scope

Section __.1 of the proposed rule specifies the scope of swap and security-based swap transactions to which the margin requirements apply. It provides that the margin requirements apply to all non-cleared swaps and security-based swaps into which a covered swap entity enters, regardless of the type of transaction or the nature of the counterparty. It also provides that the margin requirements apply only to swap and security-based swap transactions that are entered into on or after the date on which the proposed rule becomes effective.

1. Treatment of Pre-Effective Date Derivatives

The Agencies note that it is possible that a covered swap entity may enter into swap or security-based swap transactions on or after the proposed rule's effective date pursuant to the same master netting agreement with a counterparty that governs existing swaps or security-based swaps entered into prior to the effective date. As discussed below, the proposed rules permit a covered swap entity to (i) calculate initial margin requirements for swaps and security-based swaps under a qualifying master netting agreement with the counterparty on a portfolio basis in certain circumstances, if it is using an initial margin model to do so, and (ii) calculate variation margin requirements under the proposed rule on an aggregate, net basis under a qualifying master netting agreement with the counterparty. Applying the new margin rules in such a way would, in some cases, have the effect of applying the margin rules retroactively to pre-effective-date swaps under the master agreement. Accordingly, in the case of initial margin, a covered swap entity using an initial margin model would be permitted, at its option, to calculate the initial margin requirements on a portfolio basis but include only post-effective-date derivatives in the relevant portfolio.[34] With respect to variation margin, the Agencies expect that the covered swap entity will comply with the margin requirements with respect to all swaps and security-based swaps governed by a master agreement, regardless of the date on which they were entered into, consistent with current industry practice. The Agencies request comment on (i) what, if any, practical difficulties might be raised by the proposed approach to application of the margin requirements under master agreements governing both pre- and post-effective-date swaps and security-based swaps and (ii) whether there are alternative approaches that might better address the issues raised by such master agreements.

2. Treatment of Derivatives With Commercial End User Counterparties

Following passage of the Dodd-Frank Act, various observers expressed concerns regarding whether sections 731 and 764 of the Dodd-Frank Act authorize or require the CFTC, SEC, and Agencies to establish margin requirements with respect to transactions between a covered swap entity and a "commercial end user" (*i.e.,* a nonfinancial counterparty that engages in derivatives activities to hedge commercial risk),[35] and have argued that swaps and security-based swap transactions with these types of counterparties should be excluded from the scope of margin requirements imposed under sections 731 and 764 because commercial firms engaged in hedging activities pose a reduced risk to their counterparties and the stability of the U.S. financial system. In addition, statements in the legislative history of sections 731 and 764 suggest that Congress did not intend, in enacting these sections, to impose margin requirements on nonfinancial end users engaged in hedging activities, even in cases where they entered into swaps or security-based swaps with swap entities.[36]

In formulating the proposed rule, the Agencies have carefully considered these concerns and statements. The plain language of sections 731 and 764 provides that the Agencies adopt rules for covered swap entities imposing margin requirements on *all non-cleared swaps.* Those sections do not, by their terms, exclude a swap with a counterparty that is a commercial end user.

Importantly, those sections also provide that the Agencies adopt margin requirements that (i) help ensure the safety and soundness of the covered swap entity and (ii) are appropriate for the risk associated with the non-cleared swaps and non-cleared security-based swaps it holds as a swap entity. Thus, the statute requires the Agencies to take a risk-based approach to establishing margin requirements.

The proposed rule follows this statutory framework and proposes a risk-based approach to imposing margin requirements in which nonfinancial end users are categorized as lower-risk counterparties than financial end users. In particular, the proposed rule permits covered swap entities to adopt, where appropriate, initial and variation margin thresholds below which a covered swap entity is not required to collect initial and/or variation margin from counterparties that are end users because of the lesser risk posed by these types of counterparties to covered swap entities and financial stability with respect to exposures below these thresholds. The Agencies note that this threshold-based approach is consistent with current market practices with respect to nonfinancial end users, in which derivatives dealers view the

[33] For the duration of the conservatorships of Fannie Mae and Freddie Mac (together, the Enterprises), FHFA has directed that their existing regulatory capital requirements would not be binding. However, FHFA continues to closely monitor the Enterprises' activities. Such monitoring, coupled with the unique financial support available to the Enterprises from the United States Treasury and the likelihood that FHFA will promulgate new risk-based capital rules in due course to apply to the Enterprises (or their successors) once the conservatorships have ended, lead to FHFA's preliminary view that the reference to existing capital rules is sufficient to address the risks discussed in the text above as to the Enterprises.

[34] *See* proposed rule § __.8(b). The covered swap entity would *not* be permitted to selectively incorporate only certain pre-effective-date derivatives.

[35] Although the term "commercial end user" is not defined in the Dodd-Frank Act, it is generally understood to mean a company that is eligible for the exception to the mandatory clearing requirement for swaps and security-based swaps under section 2(h)(7) of the Commodity Exchange Act and section 3C(g) of the Securities Exchange Act, respectively. This exception is generally available to a person that (i) is not a financial entity, (ii) is using the swap to hedge or mitigate commercial risk, and (iii) has notified the CFTC or SEC how it generally meets its financial obligations with respect to non-cleared swaps or security-based swaps, respectively. *See* 7 U.S.C. 2(h)(7) and 15 U.S.C. 78c–3(g).

[36] *See, e.g.,* 156 Cong. Rec. S5904 (daily ed. July 15, 2010) (statement of Sen. Lincoln).

question of whether and to what extent to require margin from their counterparties as a credit decision.[37]

Under the proposed rule, a covered swap entity would not be required to collect initial or variation margin from a nonfinancial end user counterparty as long as the covered swap entity's exposures to the nonfinancial end user were below the credit exposure limits that the covered swap entity has established under appropriate credit processes and standards. The Agencies preliminarily believe that this approach is consistent with the statutory requirement that the margin requirements be risk-based, and is appropriate in light of the minimal risks that nonfinancial end users pose to the safety and soundness of covered swap entities and U.S. financial stability, particularly in cases of relatively small margin exposures.

To the extent that a covered swap entity has adopted an initial margin threshold amount or a variation margin threshold amount for a nonfinancial end user counterparty but the cumulative required initial margin or variation margin, respectively, for transactions with that end user exceeds the initial margin threshold amount or variation margin threshold amount, respectively, the covered swap entity would be required to collect the excess amount. The Agencies preliminarily believe that this approach is appropriate for the greater risk posed by such counterparties where margin exposures are relatively large.

The Agencies request comment on the appropriateness of the proposed rule's approach to a covered swap entity's transactions with nonfinancial end users and whether there are alternative approaches that would better achieve the objective of sections 731 and 764 of the Dodd-Frank Act. In particular, the Agencies note that under other provisions of the Dodd-Frank Act, nonfinancial end users that engage in derivatives to hedge their commercial risks are exempt from the requirement that all designated swaps and security-based swaps be cleared by a derivatives clearing organization or clearing agency, respectively. A major consequence of clearing a swap or security-based swap is a requirement that each party to the transaction post initial margin and variation margin to the derivatives clearing organization or clearing agency, and the exemption from the clearing requirement permits a nonfinancial end user taking advantage of the exemption to avoid posting margin to such central CCPs. Although the Dodd-Frank Act does not contain an express exemption from the margin requirement of sections 731 and 764 of the Dodd-Frank Act that is similar to the exemption for commercial end users from the mandatory clearing requirements of sections 723 and 763 of the Dodd-Frank Act, the Agencies note that the proposed rule's approach to margin requirements for derivatives with nonfinancial end users could be viewed as lessening the effectiveness of the clearing requirement exemption for these nonfinancial end users as concerns margin.

In particular, the Agencies request comment on the following questions:

Question 1(a). Does the nonfinancial end user exemption from the mandatory clearing requirement suggest or require that swaps and security-based swaps involving a nonfinancial end user should or must be exempt from initial margin and variation margin requirements for non-cleared swaps and security-based swaps? 1(b) If so, upon what statutory basis would such an exemption rely? 1(c) Should that determination vary based on whether a particular non-cleared swap or non-cleared security-based swap is subject to the mandatory clearing regime or not (*i.e.,* whether the nonfinancial end user is actually using the clearing exemption)?

Question 2. Should counterparties that are small financial institutions using derivatives to hedge their risks be treated in the same manner as nonfinancial end users for purposes of the margin requirements?

3. Effective Date

Section __.1 of the proposed rule provides that the proposed rule shall be effective with respect to any swap or security-based swap to which a covered swap entity becomes a party on or after the date that is 180 days following publication of the final rule in the **Federal Register**. The Agencies request comment regarding the appropriateness of this 180-day period.

The Agencies expect that covered swap entities are likely to need to make a number of changes to their current derivatives business operations in order to achieve compliance with the proposed rules, including potential changes to internal risk management and other systems, trading documentation, collateral arrangements, and operational technology and infrastructure. In addition, the Agencies expect that covered swap entities that wish to calculate initial margin using an initial margin model will need sufficient time to develop such models and obtain regulatory approval for their use. The Agencies request comment on the following implementation questions:

Question 3(a). What changes to internal risk management and other systems, trading documentation, collateral arrangements, operational technology and infrastructure or other aspects of a covered swap entity's derivatives operations will likely need to be made as part of the implementation of the proposed rule, and how much time will likely be required to make such changes? 3(b) Is the proposed rule's 180-day period sufficient?

Question 4(a). How much time will covered swap entities that wish to calculate initial margin using an initial margin model need to develop such models? 4(b) Is the proposed rule's 180-day period sufficient?

B. Section __.2: Definitions

Section __.2 of the proposed rule provides definitions of the key terms used in the proposed rule. In particular, § __.2 (i) defines the four types of swap and security-based swap counterparties that form the basis of the proposed rule's risk-based approach to margin requirements and (ii) provides other key operative terms that are needed to calculate the amount of initial and variation margin required under other sections of the proposed rule.

1. Counterparty Definitions

The four types of counterparties defined in the proposed rule are (in order of highest to lowest risk): (i) Swap entities; (ii) high-risk financial end users; (iii) low-risk financial end users; and (iv) nonfinancial end users.

a. "Swap entities"

The proposed rule defines "swap entity" as any entity that is required to register as a swap dealer, major swap participant, security-based swap dealer or major security-based swap participant.[38] Non-cleared swaps transactions with counterparties that are themselves swap entities pose risk to the financial system because swap entities are large players in swap and security-based swap markets and therefore have the potential to generate systemic risk through their swap activities. Because of their interconnectedness and large presence in the market, the failure of a single

[37] In the case of a nonfinancial end user with a strong credit profile, under current market practices a derivatives dealer would not require margin—in essence, it would extend unsecured credit to the end user with respect to the underlying exposure. For counterparties with a weak credit profile, a derivatives dealer would likely make a different credit decision and require the counterparty to post margin.

[38] *See* proposed rule § __.2(y).

swap entity could cause severe stress throughout the financial system.[39] Accordingly, it is the preliminary view of the Agencies that all non-cleared swap transactions with swap entities should require margin.

b. "Financial end users" and "nonfinancial end users"

Non-cleared swap transactions with end users (*i.e.,* those counterparties that are not themselves swap entities) can also pose risks to covered swap entities. Among end users, financial end users are considered more risky than nonfinancial end users because the profitability and viability of financial end users is more tightly linked to the health of the financial system than nonfinancial end users. Because financial counterparties are more likely to default during a period of financial stress, they pose greater systemic risk and risk to the safety and soundness of the covered swap entity. Section __.2 of the proposed rule defines a financial end user as any counterparty, other than a swap entity, that is: (i) A commodity pool (as defined in section 1a(5) of the Commodity Exchange Act (7 U.S.C. 1a(5))); (ii) a private fund (as defined in section 202(a) of the Investment Advisors Act of 1940 (15 U.S.C. 80–b–2(a))); (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 (29 U.S.C. 1002)); (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 of 1956 (12 U.S.C. 1843(k)); [40] (v) a person that would be a commodity pool or private fund if it were organized under the laws of the United States or any State thereof; and (vi) any other person that one of the Agencies may designate with respect to covered swap entities for which it is the prudential regulator.[41]

The proposed definition of a counterparty that is a financial end user also includes any government of any foreign country or any political subdivision, agency, or instrumentality thereof.[42] The Agencies note that these types of sovereign counterparties do not fit easily into the proposed rule's categories of financial and nonfinancial end users. In comparing the characteristics of sovereign counterparties with those of financial and nonfinancial end users, the Agencies preliminarily believe 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 end user 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 Agencies propose to treat sovereign counterparties as financial end users for purposes of the proposed rule's margin requirements.

The proposed rule defines a nonfinancial end user as any counterparty that is an end user but is not a financial end user.

c. "High-risk financial end user" and "low-risk financial end user"

A financial end user counterparty whose derivatives activities are relatively limited and pose little or no risk is classified as a low-risk financial end user; other end user counterparties are classified as high-risk financial end users. The likelihood of a financial end user counterparty's failure with respect to a covered swap entity during stressed market conditions increases with, among other things, the size and riskiness of its derivatives activity, and the potential impact to the covered swap entity's safety and soundness increases with the size of its non-cleared swaps exposure to the end user counterparty. Accordingly, the proposed rule is structured so that a covered swap entity would generally be required to reduce its counterparty exposure through more stringent margin collection requirements with respect to non-cleared derivatives with financial end user counterparties having greater and riskier derivatives activities.

Section __.2 of the proposed rule deems a financial end user counterparty to be a low-risk financial end user only if it meets *all* of the following three criteria:

- Its swaps or security-based swaps fall below a specified "significant swaps exposure" threshold;
- It predominantly uses swaps to hedge or mitigate the risks of its business activities, including balance sheet, interest rate, or other risk arising from the business of the counterparty; and
- It is subject to capital requirements established by a prudential regulator or state insurance regulator.[43]

With respect to the first criterion, the definition of "significant swaps exposure" under the proposed rule is very similar to the definition of "substantial counterparty exposure" proposed by the CFTC and SEC for purposes of establishing what level of swap and security-based swap counterparty exposure would require a person to register as a major swap participant or major security-based swap participant under the Commodity Exchange Act or the Securities Exchange Act, respectively, except that the threshold amounts are established at half the level that would require registration as a major swap participant or major security-based swap participant.[44] The proposed rule's definition is thus intended to capture persons that, while not having derivatives positions rising to the level requiring margin requirements and comprehensive regulation as a major swap participant, nonetheless have substantial activity in the market and are more likely to pose greater risk to covered swap entities with which they transact than persons with only minor activity in the market. The Agencies request comment on whether this definition of significant swaps exposure is appropriate, or whether an alternative threshold amount or definition would be more consistent with the purposes of sections 731 and 764 of the Dodd-Frank Act.

The second criterion of the proposed definition of a low-risk financial end user references the purpose for which the financial end user enters into swaps or security-based swaps. This criterion

[39] This is consistent with the Dodd-Frank Act's requirement that the Agencies set margin and capital requirements appropriate for the risk to the financial system associated with non-cleared swaps held as a swap dealer or major swap participant. 7 U.S.C. 6(e)(3)(A); 15 U.S.C. 78*o*–8(e)(3)(A).

[40] Although the proposed rule does not define 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 of 1956 (12 U.S.C. 1843(k)), the Agencies note that the Board has recently issued a proposed rule for comment defining a similar term for purposes of Title I of the Dodd-Frank Act. See 76 FR 7,731 (Feb. 11, 2011) (proposed rule). The Agencies request comment on whether they should apply the same methodology as is adopted for purposes of Title I of the Dodd-Frank Act for purposes of this clause of the proposed rule's definition of a financial end user, or whether an alternative methodology is appropriate.

[41] *See* proposed rule § __.2(h). This definition of "financial end user" is based upon, and substantially similar to, the definition of a "financial entity" that is ineligible to use the end user exemption from the mandatory clearing requirements of sections 723 and 763 of the Dodd-Frank Act. *See* 7 U.S.C. 2(h)(7); 15 U.S.C. 78c–3(g).

[42] *See* proposed rule § __.2(h)(6).

[43] *See* proposed rule § __.2(n).

[44] *See* 75 FR 80,174 (Dec. 10, 2010).

generally mirrors the description of hedging-related swaps and security-based swaps that are excluded for purposes of determining whether a person maintains a substantial position in swaps or security-based swaps and therefore meets the definition of a major swap participant or major security-based swap participant under the Commodity Exchange Act and Securities Exchange Act, respectively.[45] This distinction reflects the fact that persons using derivatives predominantly to hedge or mitigate risks arising from their business, rather than to speculate for profit, are likely to pose less risk to the covered swap entity (*e.g.,* because losses on a hedging-related swap will usually be accompanied by offsetting gains on the related position that it hedges).

The third criterion of the proposed definition of low-risk financial end user references whether the financial end user is subject to regulatory capital requirements. This criterion also generally mirrors the description of certain financial companies that are excluded from one prong of the definition of a major swap participant or major security-based swap participant under the Commodity Exchange Act and the Securities Exchange Act, respectively.[46] This distinction reflects the fact that financial end users that are subject to regulatory capital requirements are likely to pose less risk as counterparties (*e.g.,* because the requirements ensure that minimum amounts of capital will be available to absorb any losses on their derivatives transactions).

The Agencies request comment on whether the proposed rule's categorization of various types of counterparties by risk, and the key definitions used to implement this risk-based approach, are appropriate, or whether alternative approaches or definitions would better reflect the purposes of sections 731 and 764 of the Dodd-Frank Act.

Question 5. Do the definitions adequately identify financial end user counterparties that are high-risk and low-risk?

Question 6(a). Should nonfinancial end users also be separated into high-risk and low-risk categories for purposes of the margin requirements? 6(b) If so, on what basis (*e.g.,* in a manner similar to the classification of high-risk and low-risk financial end users)? 6(c) If so, how should the margin requirement apply differently to such high-risk and low-risk nonfinancial end users?

Question 7(a). Is the classification of sovereign counterparties as financial end users appropriate in light of the risks posed by these counterparties? 7(b) If not, what other classification would be appropriate, and why?

Question 8(a). Should sovereign counterparties receive their own distinct counterparty classification that is different from those classifications in the proposed rule? 8(b) If so, why? 8(c) How should the permitted uncollateralized exposures to a sovereign counterparty differ from those that are allowed for financial or nonfinancial end users?

Question 9. Is it appropriate to distinguish between financial and non-financial counterparties for the purpose of this risk-based approach?

Question 10. What other factors or tests should be used to determine the relative risk of an end user counterparty?

Question 11(a). Does the proposed rule require greater clarity with respect to the treatment of U.S. Federal, state, or municipal government counterparties? 11(b) If so, how should such counterparties be treated?

Question 12. 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?

The Agencies also request comment on the other definitions included in the proposed rule, including those discussed in further detail below.

C. Section __.3: Initial Margin

Section __.3 of the proposed rules specifies the manner in which a covered swap entity must calculate the initial margin requirement applicable to its swaps and security-based swaps. These initial margin requirements apply only to the amount of initial margin that a covered swap entity is required to collect from its counterparties; they do not address whether, or in what amounts, a covered swap entity must *post* initial margin to a derivatives counterparty. Except as described below in the summary of § __.6 of the proposed rule, the posting of initial margin by a covered swap entity to a counterparty is generally left to the mutual agreement of the covered swap entity and its counterparty. In the case where a covered swap entity enters into a swap with a counterparty that itself is a swap entity, its counterparty is likely to be subject to a regulatory margin requirement under section 731 or section 764 requiring it to collect margin from its counterparties. Thus, both parties to a non-cleared swap between two swap entities will have to collect and post margin as required by the SEC, CFTC or their prudential regulator, as applicable.[47]

1. Calculation Alternatives

The proposed rule permits a covered swap entity to select from two alternatives for calculating its initial margin requirements. In all cases, the initial margin amount required under the proposed rule is a *minimum* requirement; covered swap entities are not precluded from collecting additional initial margin (whether by contract or subsequent agreement with the counterparty) when they believe it is appropriate or preferable to do so.

Under the first alternative, a covered swap entity may calculate its initial margin requirements using a standardized "lookup" table that specifies the minimum initial margin that must be collected as a percentage of the swap or security-based swap notional amount, which percentage varies depending on the broad asset class of the swap or security-based swap.[48] If the covered swap entity has entered into more than one swap or security-based swap with a counterparty (*i.e.,* a portfolio of swaps), the aggregate minimum initial margin required on those swaps and security-based swaps would be determined by summing the minimum initial margin requirement for each individual swap.

In many cases, however, the use of a standardized table may not accurately reflect the risk of a portfolio of swaps or security-based swaps, because the swaps or security-based swaps themselves vary in ways not reflected by the standardized table or because no reduction in required initial margin to reflect offsetting exposures, diversification, and other hedging benefits is permitted, as discussed below. For this reason, the proposed rule includes a second alternative.

Under the second alternative, a covered swap entity may calculate its minimum initial margin requirements

[45] *See* 7 U.S.C. 1a(33)(A)(i)(I); 15 U.S.C. 78c(a)(67)(a)(ii)(I).

[46] *See* 7 U.S.C. 1a(33)(A)(iii)(I); 15 U.S.C. 78c(a)(67)(a)(ii)(III)(aa).

[47] Separately, in the case of institutions regulated by FHFA and FCA, the effect of § __.11 of the proposed rule, when combined with the margin requirements contained in other parts of the proposed rule, would also be to effectively require both parties to a non-cleared swap or non-cleared security-based swap between a swap entity and an institution regulated by FHFA or FCA to both collect and post initial margin.

[48] *See* proposed rule §§ __.2(k)(1), __.3(a). Although the Agencies intend to specify a particular percentage in the final rule, the proposed rule provides a potential range of percentages for comment.

using an internal margin model that meets certain criteria and has been approved by the relevant prudential regulator.[49] Specifically, the covered swap entity must collect at least the amount of initial margin that is required under its internal model calculations (subject to any applicable initial margin threshold amount, as described below).

The Agencies request comment on whether the use of internal models or Appendix A is appropriate for the calculation of initial margin requirements. In particular, the Agencies request comment on the following questions:

Question 13. As an alternative to Appendix A, should the rule allow an alternative calculation method that would link the margin on a non-cleared swap or non-cleared security-based swap to the margin required by a derivatives clearing organization for a cleared swap or cleared security-based swap whose terms and conditions closely resemble the terms and conditions of the non-cleared swap or non-cleared security-based swap?

Question 14. Would there be enough similarity between cleared and non-cleared swaps or security-based swaps to make this approach workable?

Question 15. With respect to either alternative for calculating initial margin requirements, should swap or security-based 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?

The Agencies also request comment on whether offsetting exposures, diversification, and other hedging benefits of multiple derivatives transactions can or should be more accurately represented in Appendix A's standardized table. The Agencies note that although the use of an initial margin model will allow for significant recognition of offsetting exposures, diversification, and other hedging benefits of swap and security-based swap positions that are conducted under a qualifying master netting agreement, Appendix A's standardized table is based upon gross notional amounts and recognizes no offsetting exposures, diversification, or other hedging benefits. In particular, the gross notional amount may not accurately reflect the size or riskiness of the actual position in many circumstances. For example, with respect to a swap portfolio containing (i) a one year pay fixed and receive floating interest rate swap with a notional value of $10 million and (ii) a two year pay floating and receive fixed interest rate swap with a notional value of $10 million, an initial margin model would recognize that much of the risk of the one year swap is offset by the risk of the two year swap—changes in the level of interest rates that increase the value of the one year swap will simultaneously decrease the value of the two year swap. Under Appendix A, however, the gross notional interest rate swap position would be $20 million and the initial margin on the portfolio would be twice the initial margin of either $10 million swap even though the trades are, in fact, risk reducing.

The Agencies are concerned that the use of gross notional amounts alone in determining initial margin may not adequately recognize offsetting exposures, diversification, and other hedging benefits that are well understood as in the above example. This lack of recognition might lead to large disparities between a firm that uses a model to set initial margin and a firm that uses the standardized initial margin requirements. These disparities may give rise to significant competitive inequities between firms that do and do not adopt an approved initial margin model.

The Agencies request comment on possible changes to the standardized method of calculating initial margin requirements to better reflect the effect of offsets and hedging when swaps and security-based swaps are conducted under a qualifying master netting agreement. In particular, the Agencies seek comment on the following questions:

Question 16. Would calculating the standardized initial margin for a particular risk category by separately calculating the initial margin required on the long positions and short positions and then using only the higher of these two amounts adequately account for offsetting exposures, diversification, and other hedging benefits within a standardized initial margin framework?

Question 17. Would the method described above systematically overestimate or underestimate offsetting exposures, diversification, and other hedging benefits? Is this method prone to manipulation or other gaming concerns?

Question 18. Should the Agencies consider some degree of offset across risk categories? If so how should these offsets be determined?

Question 19. Would adjusting the gross notional amount of swap positions in a particular risk category (*e.g.,* commodity, credit, equity, or foreign exchange/interest rate) by a net-to-gross ratio or a netting factor in a manner that is similar to the method used for adjusting potential future exposure calculations for purposes of the Federal banking agencies' risk-based capital rules adequately capture offsetting exposures, diversification, and other hedging benefits?

Question 20. Would adjustment of gross notional amounts with a net-to-gross ratio or a netting factor systematically overestimate or underestimate offsetting exposures, diversification, and other hedging benefits?

Question 21. Are there additional methods that could be used in conjunction with a standardized lookup initial margin table that adequately recognize offsetting exposures, diversification, and other hedging benefits?

Question 22(a). Are such methods transparent and implementable? 22(b) Can they be generalized across multiple risk categories and swap types?

As an alternative, the Agencies request comment on whether Appendix A should be revised to adopt a method that more fully reflects the offsetting of positions at default. For example, such a method might rely on a calculation of an adjusted gross notional amount that would reduce the amount of initial margin required when a counterparty has many offsetting trades under a qualifying master netting agreement. To calculate the adjusted gross notional amount for an asset class, one would first calculate the net notional to gross notional ratio. This netting factor would be the absolute value of the difference between the long notional contracts and the short notional contracts divided by the total gross notional amount of the contracts. This value would then be used as a type of correlation factor among the contracts. The adjusted gross notional amount would then be calculated as follows, where *n* is the gross notional value of trades in an asset class and "*NF*" is the netting factor:

[49] *See* proposed rule §§ __.2(k)(2), __.3(a).

$$adjusted\ gross\ notional = n \times \frac{\sqrt{n + n(n-1)NF}}{n}$$

The adjusted gross notional amount, rather than the gross notional amount, would then be used to calculate initial margin using Appendix A.

When the netting factor is zero, initial margin would still be required to be collected, and when the net to gross ratio is one (all positions are one way) the netting factor is also one so that the adjusted gross notional is equal to the gross notional. This method would allow offsetting transactions that reduce risk to reduce initial margin, but would not allow the offset to ever be perfect, so that initial margin would always be required to be collected. The adjusted gross notional method would be applied to the initial margin calculation by using gross notional amounts within an asset class. The Agencies seek comment on these methods, as well as alternative methods for calculating initial margin requirements under Appendix A and potential ways in which Appendix A might better capture the offsetting exposures, diversification, and other hedging benefits.

2. Initial Margin Thresholds

As part of the proposed rule's initial margin requirements, a covered swap entity using either alternative is also permitted to establish, for counterparties that are low-risk financial end users or nonfinancial end users, a credit exposure limit below which it need not collect initial margin.[50] A covered swap entity is not permitted to establish an initial margin threshold amount for a counterparty that is either (i) a covered swap entity itself or (ii) a high-risk financial end user.[51]

This credit exposure limit is defined in the proposed rule as the initial margin threshold amount.[52] The maximum initial margin threshold amount that a covered swap entity may establish varies based on the relative risk of the counterparty, as determined by counterparty type (*e.g.,* financial versus nonfinancial end user). With respect to a counterparty that is a low-risk financial end user, the proposed rule limits the maximum initial margin threshold amount that a covered swap entity may establish for a particular counterparty to the lower of (i) a range of $15 to $45 million or (ii) a range of 0.1 to 0.3 percent of the covered swap entity's tier 1 capital.[53] Although the Agencies have proposed a range of specific maximum initial margin threshold amounts for a counterparty that is a low-risk financial end user, the Agencies' preliminary view is that the midpoint of each range would in each case be an appropriate amount. With respect to counterparties that are nonfinancial end users, the proposed rule does not place a specific limit on the maximum initial margin threshold amount that a covered swap entity may establish.

The proposed rule allows uncollateralized exposures below the initial margin threshold amount for certain counterparties because taking uncollateralized credit exposure to counterparties is a long established business practice at the firms regulated by the Agencies. When well managed, taking on credit exposure does not automatically lead to unacceptable levels of systemic risk. Credit exposure can arise from a number of activities that regulated firms are permitted to engage in with a counterparty—making a loan, opening a committed line of credit, providing payments processing or transaction services, or engaging in swaps transactions. Although the proposal permits such credit exposure in certain circumstances, the proposed rule seeks to ensure that initial margin is collected in amounts that are appropriate to the risks posed by counterparties that are low-risk financial end users or nonfinancial end users.

The proposed rule requires that any credit exposure limit that a covered swap entity establishes as an initial threshold amount for a counterparty (i) appropriately take into account and address the credit risk posed by the counterparty and the risks of such swaps and security-based swaps and (ii) be reviewed, monitored, and approved in accordance with the swap entity's credit processes. Threshold amounts that are established in accordance with these standards are unlikely to generate meaningful risk to the safety and soundness of the covered swap entity and do not pose systemic risk.[54] In addition, in the case of counterparties that are low-risk financial end users, which the Agencies preliminarily believe pose greater risk than nonfinancial end users, the proposed rule imposes additional restrictions by limiting the maximum initial margin threshold amount that a covered swap entity may establish.

The Agencies expect that covered swap entities will establish initial margin threshold amounts only when they have meaningfully evaluated the creditworthiness of the counterparty and have made a credit and risk management decision to expose themselves to the unsecured credit of the counterparty pursuant to their generally applicable credit approval processes. The Agencies also expect that covered swap entities will monitor initial margin threshold amounts and adjust them downward to reflect any deterioration in the credit quality of the counterparty or other increase in the risks the counterparties' swaps and security-based swaps pose. Under the proposed rule, even where an initial margin threshold amount is established, the covered swap entity must still calculate the initial margin amount for the counterparty pursuant to § __.3 of the proposed rule and, to the extent that the initial margin amount exceeds the initial margin threshold amount that has been established, collect initial margin equal to the excess amount.

For those counterparties that pose the greatest threat to systemic stability by virtue of their interconnectedness and the size of their uncollateralized and potential outward exposures—namely, other swap entities and high-risk financial end users—the proposed rule

[50] *See* proposed rule §§ __.2(m), __.3(a). A covered swap entity that has established an initial margin threshold amount for a counterparty need only collect initial margin if the required amount exceeds the initial margin threshold amount, and in such cases is only required to collect the excess amount.

[51] *See* proposed rule § __.2(m)(1).

[52] *See* proposed rule § __.2(m).

[53] Although the Agencies intend to specify particular amounts in the final rule, the proposed rule provides a potential range of numbers for comment. Since tier 1 capital is not a concept that is applicable to covered swap entities for which FHFA or the FCA is the prudential regulator, the thresholds as applied to such entities instead reference (i) in the case of covered swap entities for which FHFA is the prudential regulator, the term "total capital," as separately defined within the proposed regulatory text of FHFA's proposed rule, and (ii) in the case of covered swap entities for which the FCA is the prudential regulator, the term "applicable core surplus or core capital (or successor high quality capital requirement)," as separately defined within the proposed regulatory text of the FCA's proposed rule.

[54] The Agencies also note that the categories of counterparties for which the proposed rule permits a covered swap entity to establish an initial margin threshold amount are roughly aligned with the Dodd-Frank Act exemption of non-financial end users from the Dodd-Frank Act mandatory clearing requirement. *See* 7 U.S.C. 2(h)(7); 15 U.S.C. 78c–3(g).

does not permit any exposure to remain uncollateralized; the threshold amount is effectively zero. It is the preliminary view of the Agencies that the potential systemic risk from other swap entities should lead to an amount of initial margin being actually collected. Margin should also be collected for all non-cleared swaps and non-cleared security-based swaps with high-risk financial end users because, as previously discussed, they are more likely to default during periods of financial stress and thus pose greater systemic risk and risk to the safety and soundness of the covered swap entity.

The Agencies request comment regarding whether it is appropriate to permit covered swap entities to establish initial margin threshold amounts for certain counterparties in the manner proposed. In particular, the Agencies request comment on the following questions:

Question 23(a). Does the maximum initial margin threshold amount proposed for counterparties that are low-risk financial end users strike an appropriate balance between traditional credit extension practices and the potential for systemic risk or risk to the safety and soundness of a covered swap entity? 23(b) Should threshold amounts for nonfinancial end users be subject to a similar limit? 23(c) If so, at what maximum amount or amounts? 23(d) Do the derivatives activities and exposures of nonfinancial end users have the potential to create systemic risk, either individually or in aggregate?

Question 24. Is it appropriate for the threshold amounts to be capped at a fixed dollar amount?

Question 25. Should the rule also place a limit on the threshold amounts that a covered swap entity establishes for all counterparties in the aggregate?

Question 26(a). Is it appropriate for the threshold amounts to be determined by reference to the tier 1 or other measure of capital of a covered swap entity? 26(b) What other measures might be used to determine appropriate threshold amounts?

Question 27(a). Should the various threshold amounts be subject to an automatic adjustment for inflation on a periodic basis? 27(b) If so, what type of adjustment would be appropriate?

3. Minimum Transfer Amount

In addition, the proposed rule provides for a minimum transfer amount for the collection of margin by covered swap entities, under which a covered swap entity need not collect initial margin from any individual counterparty otherwise required under the proposed rule until the required cumulative amount is $100,000 or more.[55]

4. Alternative Approach to Initial Margin Requirements

The Agencies also request comment on several alternative approaches to implementation of the initial margin requirements.

First, the Agencies request comment on whether the proposed rule should be augmented by (i) imposing a separate, additional requirement that a covered swap entity *post* initial margin to any counterparty that is an end user, including both financial and nonfinancial end users and (ii) requiring the covered swap entity to ensure that any such initial margin posted is segregated at a third-party custodian. In particular, the Agencies request comment on the following questions:

Question 28. Would requiring a covered swap entity to post initial margin to end user 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)?

Question 29. Are there alternatives that address those risks more efficiently or with greater transparency?

Question 30. Would requiring a covered swap entity to post initial margin to end user counterparties raise any concerns with respect to the safety and soundness of the covered swap entity, taking into consideration the requirement that initial margin be segregated and held with a third party custodian?

Question 31. Would requiring a covered swap entity to post initial margin to end user counterparties remove one or more incentives for that covered swap entity to choose, where possible, to structure a transaction so that it need not be cleared through a CCP in order to avoid pledging initial margin?

Question 32. Would this approach be consistent with the statutory factors the Agencies are directed to take into account under sections 731 and 764 of the Dodd-Frank Act?

Second, the Agencies request comment on whether the proposed rule should be augmented by (i) imposing a separate, additional requirement that a covered swap entity *post* initial margin to any end user counterparty that is a systemically significant financial institution under Title I of Dodd-Frank Act, and (ii) requiring the covered swap entity to ensure that any such initial margin posted is segregated at a third-party custodian. In particular, the Agencies request comment on the following questions:

Question 33. Would requiring a covered swap entity to post initial margin to systemically-significant end user 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)?

Question 34. Are there alternatives that address those risks more efficiently or with greater transparency?

Question 35. Would requiring a covered swap entity to post initial margin to systemically-significant end user counterparties raise any concerns with respect to the safety and soundness of the covered swap entity, taking into consideration the requirement that initial margin be segregated and held with a third party custodian?

Question 36. Would requiring a covered swap entity to post initial margin to systemically-significant end user counterparties remove one or more incentives for that covered swap entity to choose, where possible, to structure a transaction so that it need not be cleared through a CCP in order to avoid pledging initial margin?

Question 37. Would this approach be consistent with the statutory factors the Agencies are directed to take into account under sections 731 and 764 of the Dodd-Frank Act?

Third, the Agencies request comment on whether the proposed rule should establish a distinct category of covered swap entities that, because of the relatively small size of the derivatives activities and the lesser risk they pose to U.S. financial stability, would be subject to less stringent initial margin requirement. In particular, such an approach would (i) permit such "low-risk" covered swap entities to establish larger initial or additional margin threshold amounts (*e.g.,* for counterparties that are swap entities) and (ii) not require such "low-risk" covered swap entities to comply with the segregation requirements of § __.7 of the proposed rule. Such low-risk covered swap entities could be defined by identifying a particular threshold amount of derivatives activities below which one would be considered a low-risk covered swap entity. For example, under this approach, a low-risk covered swap entity might be defined as a covered swap entity whose total

[55] *See* proposed rule § __.3(c). The minimum transfer amount only affects the timing of margin collection; it does not change the amount of margin that must be collected once the $100,000 threshold is crossed. For example, if the initial margin requirement were to increase from $50,000 to $110,000, the covered swap entity would be required to collect the entire $110,000 (subject to application of any applicable initial margin threshold amount).

positions in swaps and security-based swaps are below the applicable thresholds established by the SEC and CFTC for determining whether a firm is a major swap participant or major security-based swap participant, respectively. In particular, the Agencies request comment on the following questions:

Question 38. Would establishing a category of low-risk covered swap entity and subjecting that category to less stringent initial margin requirements enhance or reduce systemic risk?

Question 39. Would establishing a category of low-risk covered swap entity and subjecting that category to less stringent initial margin requirements raise any concerns with respect to the safety and soundness of such an entity?

Question 40. If the Agencies adopted such an approach, how should a low-risk covered swap entity be defined? Should the definition reference the thresholds established by the SEC and CFTC for determining whether a firm is a major swap participant or major security-based swap participant, or some variant of those thresholds?

Question 41. What less stringent initial margin requirements should apply to such low-risk covered swap entities? What, if any, segregation requirement should apply to such low-risk covered swap entities?

Question 42. Would such an approach encourage covered swap entities to separate their derivatives activities into multiple entities so as to avail themselves of the exemption?

Question 43. Would this approach be consistent with the statutory factors the Agencies are directed to take into account under sections 731 and 764 of the Dodd-Frank Act?

D. Section __.4: Variation Margin

Section __.4 of the proposed rules specifies the manner in which a covered swap entity must calculate the variation margin requirement applicable to swaps and security-based swaps it enters into. As with initial margin requirements, (i) these variation margin requirements apply only to *collection* of variation margin by covered swap entities from their counterparties, and not to the *posting* of variation margin to their counterparties,[56] and (ii) establish only a *minimum* amount of variation margin that must be collected, leaving covered swap entities free to collect larger amounts if they so choose. Consistent with current practice, covered swap entities and their counterparties would remain free to negotiate the extent to which a covered swap entity may be required to post variation margin to a counterparty (other than a swap entity that is itself subject to margin requirements).

The proposed rule generally requires a covered swap entity to collect variation margin from its counterparties on a periodic basis.[57] The amount of variation margin that is required to be periodically collected must be equal to or greater than (i) the cumulative mark-to-market change in value to the covered swap entity of a swap or security-based swap, as measured from the date it is entered into, *less* (ii) the value of all variation margin previously collected but not returned by the covered swap entity with respect to such swap or security-based swap.[58]

1. Variation Margin Thresholds and Minimum Transfer Amounts

Similar to the initial margin requirement under § __.3 of the proposed rule, § __.4 permits a covered swap entity to establish, for certain counterparties that are end users, a credit exposure limit that acts as a variation margin threshold below which it need not collect variation margin.[59] Although the variation margin threshold is separate from, and may be applied independently from, the initial margin threshold with respect to qualifying counterparties, the variation margin threshold amount that a covered swap entity may establish for counterparties that are low-risk financial end users is subject to the same specified maximum amount that governs initial margin threshold amounts for such counterparties. As with initial margin threshold amounts, a covered swap entity may not establish a variation margin threshold amount for counterparties that are swap entities or high-risk financial end users.

In addition, the proposed rule's variation margin requirements contain provisions similar to those governing initial margin with respect to minimum transfer amounts.

2. Aggregate Calculation of Variation Margin Requirements Under a Qualifying Master Netting Agreement

The proposed rule permits a covered swap entity to calculate variation margin requirements on an aggregate basis across all swap or security-based swap transactions with a counterparty that are executed under the same qualifying master netting agreement.[60] The proposed rule defines a qualifying master netting agreement as 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.[61] The Agencies request comment regarding whether permitting the aggregate calculation of variation margin requirements is appropriate and, if so, whether the proposed rule's definition of qualifying master netting agreement raises practical or implementation difficulties or is inconsistent with current market practices.

3. Frequency of Variation Margin Calculation and Collection

The proposed rule also specifies the minimum frequency with which a covered swap entity must calculate and collect initial margin. Consistent with the approach of the proposed rule generally, the minimum frequency varies based on the systemic and safety and soundness risk of the counterparty type. Covered swap entities must calculate and collect variation margin from counterparties that are themselves swap entities or financial end users at least once per business day, and from counterparties that are nonfinancial end users at least once per week. The Agencies request comment on whether the proposed rule's approach to the frequency with which the variation margin requirements must be met is consistent with current market practices, and whether alternative approaches to imposing variation margin requirements would better reflect the purposes of section 731 and 764 of the Dodd-Frank Act.

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[56] As described in section III.K of this notice, FHFA's and the FCA's proposed rules contain an additional provision that will have a different effect with respect to entities regulated by FHFA and the FCA.

[57] *See* proposed rule § __.4(a).

[58] The proposed rule defines this required amount as the "variation margin amount." *See* proposed rule § __.2(bb). In the case of swap or security-based swap that is out-of-the-money or in-the-money to a covered swap entity at the time it enters into the transaction, that amount is also included within the definition of variation margin amount and subject to the variation margin requirements.

[59] *See* proposed rule §§ __.2(bb), __.4(a).

[60] *See* proposed rule § __.4(d).

[61] *See* proposed rule § __.2(t). The proposed rule's definition of qualifying master netting agreement generally mirrors the definition given to that term in the Federal banking agencies' risk-based capital rules applicable to derivatives positions held by insured depository institutions and bank holding companies. *See, e.g.,* 12 CFR part 225, App. G.I.2.

4. Counterparty Refusal to Provide Required Variation Margin

Section __.4(e) of the proposed rule addresses potential circumstances in which a counterparty may refuse to provide required variation margin to a covered swap entity. Specifically, it provides that a covered swap entity shall not be deemed to have violated its regulatory obligation to collect required variation margin from a counterparty if the counterparty has refused or otherwise failed to provide the required variation margin to the covered swap entity and the covered swap entity has either (i) 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 relevant Agency that it has made appropriate efforts to collect the required variation margin, or (ii) commenced termination of the swap or security-based based swap with the counterparty.[62] The Agencies note that, in each such case, the covered swap entity will have been required, under § __.5 of the proposed rule, to obtain the contractual right to collect such variation margin as is necessary to permit it to comply with the requirements of § __.4 of the proposed rule and set out valuation dispute resolution procedures.

5. Alternative Approach to Variation Margin Requirements

The Agencies also request comment on several alternative approaches to implementation of the variation margin requirements.

First, the Agencies request comment on whether the proposed rule should be augmented by imposing a separate, additional requirement that a covered swap entity *post* variation margin to any counterparty that is an end user, including both financial and nonfinancial end users. In particular, the Agencies request comment on the following questions:

Question 44. Would requiring a covered swap entity to post variation margin to end user 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)?

Question 45. Are there alternatives that address those risks more efficiently or with greater regulatory transparency?

Question 46. Would requiring a covered swap entity to post variation margin to end user counterparties raise any concerns with respect to the safety and soundness of the covered swap entity?

Question 47. Would requiring a covered swap entity to post variation margin to end user counterparties remove one or more incentives for that covered swap entity to choose, where possible, to structure a transaction so that it need not be cleared through a CCP in order to avoid pledging variation margin?

Question 48. Would this approach be consistent with the statutory factors the Agencies are directed to take into account under sections 731 and 764 of the Dodd-Frank Act?

Second, the Agencies request comment on whether the proposed rule should be augmented by imposing a separate, additional requirement that a covered swap entity *post* variation margin to any end user counterparty that is a systemically significant financial institution under Title I of Dodd-Frank Act. In particular, the Agencies request comment on the following questions:

Question 49. Would requiring a covered swap entity to post variation margin to systemically-significant end user 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)?

Question 50. Are there alternatives that address those risks more efficiently or with greater regulatory transparency?

Question 51. Would requiring a covered swap entity to post variation margin to systemically-significant end user counterparties raise any concerns with respect to the safety and soundness of the covered swap entity?

Question 52. Would requiring a covered swap entity to post variation margin to systemically-significant end user counterparties remove one or more incentives for that covered swap entity to choose, where possible, to structure a transaction so that it need not be cleared through a CCP in order to avoid pledging variation margin?

Question 53. Would this approach be consistent with the statutory factors the Agencies are directed to take into account under sections 731 and 764 of the Dodd-Frank Act?

Third, the Agencies request comment on whether the proposed rule should establish a distinct category of swap entities that, because of the relatively small size of the derivatives activities and the lesser risk they pose to U.S. financial stability, would be subject to less stringent variation margin requirement. In particular, such an approach would permit such "low- risk" covered swap entities to establish larger variation margin threshold amounts. Such low-risk covered swap entities could be defined as described in section III.C.4 of this notice. In particular, the Agencies request comment on the following questions:

Question 54. Would establishing a category of low-risk covered swap entity and subjecting such an entity to less stringent variation margin requirements enhance or reduce systemic risk?

Question 55. Would establishing a category of low-risk covered swap entity and subjecting such an entity to less stringent variation margin requirements raise any concerns with respect to the safety and soundness of such an entity?

Question 56. If the Agencies adopted such an approach, how should a low-risk covered swap entity be defined? What less stringent variation margin requirements should apply to such low risk covered swap entities?

Question 57. Would such an approach encourage covered swap entities to separate their derivatives activities into multiple entities so as to avail themselves of the exemption?

Question 58. Would this approach be consistent with the statutory factors the Agencies are directed to take into account under sections 731 and 764 of the Dodd-Frank Act?

E. Section __.5: Documentation of Margin Matters

The proposed rule requires a covered swap entity to execute trading documentation with each counterparty that includes credit support arrangements that grant the covered swap entity the contractual right to collect initial margin and variation margin in such amounts, in such form, and such circumstances as are required by the initial margin and variation margin requirements set forth in the proposed rule.[63] The trading documentation must also specify (i) the methods, procedures, rules, and inputs for determining the value of each swap or security-based swap for purposes of calculating variation margin requirements and (ii) the procedures by which any disputes concerning the valuation of swaps or security-based swaps, or the valuation of assets

[62] *See* proposed rule § __.4(e). The Agencies note that there is no similar reference to appropriate efforts in the proposed rule initial margin requirements; since initial margin is collected at the time a swap or security-based swap is entered into, a covered swap entity can and must collect any required initial margin as prerequisite to executing the transaction.

[63] *See* proposed rule § __.5.

collected or posted as initial margin or variation margin, may be resolved.[64]

F. Section __.6: Eligible Collateral

The proposed rule specifies the types of collateral that are eligible to be collected to satisfy either the initial margin or variation margin requirements. Under the proposed rule, eligible collateral is limited to: (i) Immediately available cash funds (denominated in either U.S. dollars or in 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; (iii) with respect to initial margin only, any senior debt obligations of the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, the Federal Home Loan Banks and Farmer Mac; and (iv) with respect to initial margin only, any obligation that is an "insured obligation," as that term is defined in 12 U.S.C. 2277a(3), of the Farm Credit System banks.[65] Other than immediately-available cash funds, all types of eligible collateral are subject to discounts or minimum "haircuts" for purposes of determining their value for margin purposes, which haircuts are identified in Appendix B of the proposed rule.[66] Because the value of noncash collateral may vary, the proposed rule requires covered swap entities to monitor the value of noncash collateral previously collected to satisfy initial or variation margin requirements and, to the extent the value of such noncash collateral has decreased, to collect additional collateral with a sufficient value to ensure that all applicable initial and variation margin requirements remain satisfied.[67] The proposed rule also prohibits a covered swap entity from collecting, as required initial margin or variation margin, collateral that is an obligation of the counterparty pledging such collateral.[68]

The proposed rule does *not* allow for the use of non-cash collateral, other than the limited types of highly-liquid, high-quality debt securities described above, to satisfy the margin requirements. The appropriateness of using non-cash collateral to fulfill margin requirements is complicated by procyclical considerations. During a period of financial stress, the value of non-cash collateral pledged as margin may also come under stress just as counterparties default and the non-cash collateral is required to offset the cost of replacing defaulted swap positions. In addition, given the infinite variety of potential types of noncash collateral, it is extremely difficult to establish accurate haircuts by regulation. Also, for nonfinancial end users, who are the most likely type of counterparty to wish to post noncash collateral, the proposed rules provide credit exposure thresholds, under which a covered swap entity may determine the extent to which available noncash collateral appropriately reduces the covered swap entity's credit risk, consistent with its credit underwriting expertise. Similarly, counterparties that wish to rely on other non-cash assets to meet margin requirements could pledge those assets with a bank or group of banks in a separate arrangement, such as a secured financing facility, and could draw cash from that arrangement to meet margin requirements.

The Agencies request comment on whether the proposed rule's list of eligible noncash collateral for initial margin and variation margin is appropriate in scope. In particular, the Agencies request comment on the following questions:

Question 59(a). Should the types of eligible collateral listed be broadened to include other types of assets (*e.g.* securities backed by high-quality mortgages or issued with a third-party guarantee)? 59(b) If so, how might the systemic risk issue described above be effectively mitigated?

Question 60(a). 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? 60(b) If so, which currencies (*e.g.,* those accepted by a derivatives clearing organization as initial margin for a cleared swap)? 60(c) If so, what haircut, if any, should apply to such foreign currency?

Question 61. What criteria and factors could be used to determine the set of acceptable non-cash collateral?

Question 62. How could appropriate haircuts be determined for valuing these assets for margin purposes?

Question 63(a). Should the types of eligible collateral listed be broadened to include foreign sovereign debt securities? 63(b) If so, which foreign sovereign debt securities (*e.g.,* those accepted by a derivatives clearing organization as initial margin for a cleared swap)? 63(c) If so, what haircut, if any, should apply?

Question 64(a). 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? 64(b) If so, how should the concept of a "high credit standing" be defined in a way that does not reference credit ratings?

G. Section __.7: Segregation of Collateral

The proposed rule provides that each covered swap entity must require each derivative's counterparty that it faces that is a swap entity to segregate any funds or collateral that the covered swap entity has posted as initial margin for a non-cleared swap or non-cleared security-based swap transaction at an independent, third-party custodian.[69] This independent, third-party custodian must be prohibited by contract from (i) rehypothecating or otherwise transferring any initial margin it holds for the covered swap entity and (ii) reinvesting any initial margin held by the custodian in any asset that would not qualify as eligible collateral for initial margin under the proposed rule.[70] The custodian must also be located in a jurisdiction that applies the same insolvency regime to the custodian as would apply to the covered swap entity.[71] This segregation requirement applies only to initial margin, not variation margin, and does not apply to transactions with a counterparty that is an end user of any type.[72]

[64] *See id.*

[65] *See* proposed rule § _6(a). An obligation will be considered to be fully guaranteed as to principal and interest by the United States if the guarantee commits the full faith and credit of the United States for the repayment of principal and interest on the obligation. "Insured obligations" of Farm Credit System banks are consolidated and System-wide obligations issued by Farm Credit System banks. These obligations are insured by the Farm Credit System Insurance Corporation out of funds in the Farm Credit Insurance Fund. Should the Farm Credit Insurance Fund ever be exhausted, Farm Credit System banks are jointly and severally liable for payment on insured obligations.

[66] *See* proposed rule § _6(b). With respect to these haircuts, although the Agencies intend to specify particular haircut amounts in the final rule, the proposed rule provides a potential range of haircuts for comment.

[67] *See* proposed rule § _6(d).

[68] *See* proposed rule § _6(c).

[69] *See* proposed rule § _7(a).

[70] *See* proposed rule §§ _7(b), (c).

[71] *See* proposed rule § _7(d).

[72] The proposed rule does not apply the segregation requirement to variation margin because variation margin is generally used to offset the current exposure arising from *actual* changes in the market value of the derivative position, rather than to secure potential exposure arising from *future* changes in the market value of the derivative position. Under section __.11 of FHFA's and the FCA's proposed rules, entities regulated by FHFA and the FCA that are end users would have to require that any initial margin and variation margin they post to swap entities be segregated.

The Agencies' preliminary view is that requiring covered swap entities to ensure segregation of initial margin is necessary to (i) offset the greater risk to the covered swap entity and the financial system arising from the use of swaps and security-based swaps that are not cleared and (ii) protect the safety and soundness of the covered swap entity. In developing this proposal, the Agencies have taken into account the fact that the failure of a covered swap entity could pose significant systemic risks to the financial system and losses borne by the financial system in such a failure could have significant consequences. The consequences could be magnified if the initial margin posted to the failing swap entity cannot be quickly recovered by the nondefaulting party during a period of financial stress when the liquidity value of the funds is high. Moreover, swap entities typically have roughly offsetting exposures with one another. As a result, it is to be expected that the amount of initial margin required to be posted by two swap entities will be similar. If swap entities exchange similar amounts of initial margin and these funds are available for general use and rehypothecation by the swap entities, then the net effect is as if little initial margin was exchanged. To the extent that initial margin requirements are intended to constrain risk-taking, a lack of segregation will weaken their effect.[73]

Swap entities that engage in cleared swap transactions will be required to post initial margin to the CCP. Consequently, the initial margin that is posted on cleared transactions will not be available for rehypothecation by swap entities. Allowing for rehypothecation of initial margin by swap entities would create an incentive for swap entities to engage in non-cleared transactions even though other provisions of Dodd-Frank Act are intended to promote central clearing of swaps. However, the segregation of initial margin is likely to significantly reduce the availability of liquid assets to covered swap entities to meet payment obligations, as liquid assets held or pledged as the initial margin would be unavailable to the swap entity for other purposes. The requirement to segregate initial margin could result in covered swap entities having to seek alternative methods of funding. The loss in liquidity could be severe, and could require covered swap entities to raise liquidity through other sources.

The Agencies are concerned that not requiring segregation at the outset may cause covered swap entities that incur a severe loss due to credit or market events to face liquidity challenges because their counterparties may require segregation immediately after the loss, depleting the covered swap entity's liquid assets before it can raise additional funds through other means.[74] Requiring swap entities to segregate at the outset addresses this concern at the time a swap entity suffers a loss, but depletes the liquid assets at the inception of the swap transaction—a time when the swap entity is more likely to be able to raise additional liquid funds. The Agencies request comment on whether the proposed segregation requirement is appropriate, or whether an alternative approach would better reflect the purposes of sections 731 and 764 of the Dodd-Frank Act. In particular, the Agencies request comment on the following questions:

Question 65(a). Is it necessary to require segregation of initial margin in order to address the systemic risk issues discussed above? 65(b) What alternatives to segregation would effectively address these systemic risk issues? 65(c) As an alternative to requiring segregation at the outset, should the Agencies impose rules that provide additional time for a swap dealer to raise funds without requiring segregation?

Question 66(a). What are the potential operational, liquidity and credit costs of requiring segregation of initial margin by swap entities? 66(b) 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?

Question 67. Is segregation of initial margin and not variation margin sufficient to achieve the purposes of sections 731 and 764 of the Dodd-Frank Act? If not, how might such purposes be achieved?

Question 68(a). Are the limitations placed on rehypothecation and reinvestment under the proposed rule appropriate or necessary? 68(b) What additional or alternative limitations may be appropriate? 68(c) Should certain forms of rehypothecation (*e.g.,* the lending of securities pledged as collateral) or additional types of reinvestment be permitted?

Question 69(a). 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? 69(b) What additional or alternative requirements regarding the location of the custodian may be appropriate?

H. Section __.8: Approved Initial Margin Models

Section __.8 of the proposed rule contains modeling standards that an initial margin model must meet in order for a covered swap entity to calculate initial margin under such a model. Generally, the modeling standards are consistent with current regulatory rules and best practices for such models in the context of risk-based capital rules applicable to insured depository institutions and bank holding companies, and are no less conservative than those generally used by derivatives clearing organizations and clearing agencies.[75] As a result, the Agencies preliminarily believe that these modeling standards should ensure that a non-cleared swap does not pose a greater systemic risk than a cleared swap. In particular, because non-cleared swaps are expected to be less liquid than cleared swaps, the proposed rule specifies a minimum time horizon for the initial margin model of 10 business days, compared with a typical requirement of 3 to 5 business days used by derivatives CCPs.[76]

The proposed rule permits a covered swap entity to use an internal initial margin model that reflects offsetting exposures, diversification, and other hedging benefits within four broad risk categories (commodity, credit, equity,

[73] For example, if dealer A and dealer B entered into a swap with each other under which each was required to collect $100 from the other in initial margin without segregation, each would collect $100 in initial margin from the other and no net initial margin would be exchanged. In the case of a bankruptcy of dealer B, dealer A would be permitted to set off the $100 loss that may be incurred in replacing the swap against the $100 in initial margin it "collected" from dealer B, but then would face the potential loss of the $100 in initial margin it provided to dealer B, for which it would only have a claim in bankruptcy. If instead the initial margin for such a swap had been segregated, dealer A would be permitted to set off the $100 loss that may be incurred in replacing the swap against the $100 in initial margin that dealer B pledged to dealer A at a third-party custodian, and dealer A could also recover the $100 in initial margin that it pledged to dealer B at a third-party custodian, with the result that dealer A would incur no loss upon dealer B's bankruptcy.

[74] Although the agreements between the counterparties might not allow for requests for segregation after a swap transaction has been confirmed, as a practical matter counterparties might refuse to enter into any additional transactions with a financially-stressed swaps entity absent an accommodation to segregate some amount of initial margin for the existing portfolio of swaps between the two parties.

[75] This conservative approach also incorporates the practices associated with model validation, independent review and other qualitative requirements associated with the use of internal models for regulatory capital purposes.

[76] *See* proposed rule § __.8(d)(1).

foreign exchange/interest rates) when calculating initial margin for a particular counterparty if the relevant swaps or security-based swaps are executed under the same qualifying master netting agreement.[77] The proposed rule does *not* permit an initial margin model to reflect offsetting exposures, diversification, or other hedging benefits *across* broad risk categories.[78] It is the preliminary view of the Agencies that the correlations of exposures across broad risk categories are not stable enough to be incorporated into a regulatory margin requirement.

The Agencies request comment on whether the standards for initial margin models specified in the proposed rule are sufficient to ensure the integrity of initial margin calculations using such a model. In particular, the Agencies request comment on the following questions:

Question 70(a). Should such models be limited to models based on value-at-risk concepts, or are other models appropriate to measure initial margin? 70(b) If so, how should those models apply and be incorporated into the various aspects of the proposed rule?

Question 71(a). Should offsetting exposures, diversification, and other hedging benefits be recognized more broadly across substantially dissimilar asset classes? 71(b) 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?

Question 72(a). Should the minimum time horizon vary across swaps? 72(b) For example, should it vary based on the broad asset classes: commodity, credit, equity, and foreign exchange/interest rate? 72(c) If so, how should the horizons differ and what would be the basis for the different horizons?

1. Stress Calibration

In addition to a time horizon of 10 trading days, the proposed rule requires the initial margin model to be calibrated to a period of financial stress.[79] Calibration to a stress period ensures that the resulting initial margin requirement is robust to a period of financial stress during which swap entities and financial counterparties are more likely to default. Such calibration also reduces the systemic risk associated with any increase in margin requirements that might occur in response to a large increase in volatility during a period of financial stress.

The Agencies request comment on whether the proposed requirement that an initial margin model take into account financial stress is appropriate given the purpose the initial margin model is intended to serve. In particular, the Agencies request comment on the following questions:

Question 73. Can initial margin models be robustly calibrated to a stress period in a transparent and consistent manner?

Question 74. 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?

Question 75. 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?

Question 76. Is a 10-day horizon sufficient to cover the likely liquidation period on non-cleared swaps?

Question 76. 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?

Question 77. Is "period of significant financial stress" a well-understood concept? How might it be clarified?

Question 78. 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?

Question 79. 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?

2. Benchmarking

The proposed rule requires that an initial margin model used for calculating initial margin requirements be benchmarked periodically against observable margin standards to ensure that the initial margin required is not less than what a derivatives clearing organization or a clearing agency would require for similar transactions.[80] This benchmarking requirement is intended to insure that any initial margin amount produced by an initial margin model is subject to a readily observable minimum. It will also have the effect of limiting the extent to which the use of initial margin models might disadvantage the movement of certain types of derivatives to CCPs by setting lower initial margin amounts for non-cleared transactions than for similar cleared transactions.

The Agencies request comment on the proposed requirement for covered swap entities to benchmark any initial margin model to a model used by a derivatives clearing organization or clearing agency model for calculating initial margin, as well as the following questions:

Question 80. What are the operational costs associated with the benchmarking exercise?

Question 81. Can portfolio effects be captured during the benchmarking exercise?

Question 82. How would a banking organization fulfill the requirement in the event that a derivatives clearing organization or clearing agency does not clear a similar derivative transaction?

I. Section __.9: Application of Margin Requirements to Certain Foreign Covered Swap Entities

Section __.9 of the proposed rule addresses the manner in which the proposed rule's margin requirements apply to certain foreign covered swap entities. In the absence of § __.9, the proposed rule's margin requirements would apply to all of a covered swap entity's non-cleared swap and non-cleared security-based swap transactions, without regard to whether (i) the covered swap entity is organized under U.S. or foreign law or (ii) the covered swap entity's counterparty is located inside or outside of the United States. However, the potential application of the margin rules to foreign covered swap entities, or to transactions by U.S. covered swap entities with foreign counterparties, raises several important questions. First, the potential application of the proposed rule to activities conducted by a foreign covered swap entity wholly outside of the United States raises questions regarding the permissible territorial scope of the proposed rule.[81]

[77] *See* proposed rule § __.8(b).

[78] *Id.*

[79] *See* proposed rule § __.8(d)(11).

[80] *See* proposed rule § __.8(d)(14).

[81] Section 2(i) of the Commodity Exchange Act, as amended by section 722 of the Dodd-Frank Act, provides that the provisions of the Commodity Exchange Act relating to swaps "shall not apply to activities outside of the United States unless those activities * * * have a direct and significant connection with activities in, or effect on, commerce of the United States."

Second, to the extent that the proposed margin requirements apply to transactions involving foreign covered swap entities or foreign counterparties, such application could subject these transactions to multiple, and potentially conflicting, margin requirements established by U.S. and foreign regulators. Third, the potentially different treatment of U.S. covered swap entities and foreign covered swap entities raises questions of competitive equality among the two types of firms.

With respect to U.S. covered swap entities, the Agencies propose to apply the margin requirements to U.S. covered swap entities' swap and security-based swap transactions without regard to whether the counterparty is located inside or outside the United States. This approach acknowledges that the foreign swap and security-based swap transactions of a U.S. covered swap entity pose no lesser risk to the covered swap entity's safety and soundness and to financial stability based on the location of the counterparty. The proposed rule applies that same approach to covered swap entities that are foreign subsidiaries and offices of U.S. firms.

With respect to foreign covered swap entities, the Agencies propose to exclude certain qualifying foreign derivative transactions of such entities from application of the proposed rule's margin requirements. Specifically, § __.9 of the proposed rule provides that the proposed rule's margin requirements would not apply to any "foreign non-cleared swap or foreign non-cleared security-based swap" of a "foreign covered swap entity," as those terms are defined in § __.9 of the proposed rule.[82] This proposed approach limits the extra-territorial application of the margin requirements while preserving, to the extent possible, competitive equality among U.S. and foreign firms in the United States.

For these purposes, the proposed rule defines a "foreign non-cleared swap or foreign non-cleared security-based swap" as a non-cleared swap or non-cleared security-based swap with respect to which: (i) The counterparty to the foreign covered swap entity is not a company organized under the laws of the United States or any State, not a branch or office of a company organized under the laws of the United States or any State, and not a person resident in the United States; and (ii) performance of the counterparty's obligations to the foreign covered swap entity under the swap or security-based swap has not been guaranteed by an affiliate of the counterparty that is a company organized under the laws of the United States or any State, a branch of a company organized under the laws of the United States or any State, or a person resident in the United States.[83] As a result, foreign swaps and security-based swaps would generally only include transactions where the counterparty is not organized under U.S. law or otherwise located in the United States, and no U.S. affiliate of the counterparty has guaranteed the counterparty's obligations under the transaction.[84]

The additional requirement that no U.S. affiliate guarantee the counterparty's obligation is intended to exclude instances where such an affiliate has, through a guarantee, effectively assumed ultimate responsibility for the performance of the counterparty's obligations under the transaction. In particular, the Agencies are concerned that without such a requirement, swaps and security-based swaps with a U.S. counterparty could be structured, through the use of an overseas affiliate, in a manner that would evade application of the proposed margin requirements to U.S. transactions. Transactions guaranteed by a U.S. affiliate would also have direct and significant connection with activities in, and effect on, commerce of the United States.

The proposed rule defines a "foreign covered swap entity" as a covered swap entity that: (i) Is not a company organized under the laws of the United States or any State; (ii) is not a branch or office of a company organized under the laws of the United States or any State; (iii) is not a U.S. branch, agency or subsidiary of a foreign bank; and (iv) is not controlled, directly or indirectly, by a company that is organized under the laws of the United States or any State.[85] Accordingly, only a covered swap entity that is organized under foreign law and not controlled, directly or indirectly, by a U.S. company would be eligible for treatment as a foreign covered swap entity for these purposes; neither a foreign branch of a U.S. insured depository institution nor a foreign subsidiary of a U.S. company would be considered a foreign covered swap entity under the proposed rule. In cases where a U.S. company has a foreign subsidiary that is a covered swap entity, the proposed rule would treat that foreign subsidiary in the same manner as a U.S. covered swap entity for purposes of the margin requirements because the U.S. parent company's ownership of the subsidiary is likely to expose the U.S parent company, as a result of legal, contractual or reputational factors, to the risks of the foreign subsidiary's derivatives activities. Transactions of a foreign subsidiary of a U.S. company would also have direct and significant connection with activities in, and effect on, commerce of the United States. Similarly, neither a U.S. branch of a foreign bank nor a U.S. subsidiary of a foreign company would be a foreign covered swap entity under the proposed rule.

The Agencies request comment on the proposed rule's application to the U.S. and foreign swap and security-based swap activities of U.S. covered swap entities and foreign swap entities, respectively. In particular, the Agencies request comment on the following questions:

Question 83. Does the proposed rule's treatment of the swap and security-based swap transactions of foreign covered swap entities appropriately limit application of the margin requirements in a manner consistent with the territorial scope of sections 731 and 764 of the Dodd-Frank Act?

Question 84(a). Is the proposed rule's treatment of the foreign swap and security-based swap transactions of U.S. covered swap entities appropriate? 84(b) Should such transactions be subject to the same exclusion that has been proposed for the foreign swap and security-based swap transactions of foreign covered swap entities? 84(c) If so, why?

Question 85(a). Should the proposed rule expand the definition of foreign covered swap entity to include (i) the foreign subsidiaries of U.S. companies or (ii) the foreign branches of U.S. insured depository institutions? 85(b) If so, why? 85(c) How could the potential risks to the U.S. parent company or insured depository institution related to its subsidiary or branch's activity be limited or eliminated? 85(d) Is this operationally feasible?

Question 86. What impact is the proposed rule's treatment of the foreign swap and security-based swap transactions of U.S. covered swap entities likely to have on the structure, management, and/or competitiveness of U.S. covered swap entities?

Question 87(a). Is the proposed rule's definition of a foreign swap or security-based swap transaction appropriate? 87(b) In particular, is the requirement that no U.S. affiliate guarantee the

[82] *See* proposed rule § __.9(a).

[83] *See* proposed rule § __.9(b).

[84] Under the proposed rule, swap and security-based swaps with *U.S. counterparties* are subject to the proposed rule's margin requirements regardless of whether the covered swap entity is U.S. or foreign.

[85] *See* proposed rule § __.9(c).

foreign counterparty's obligations under the swap or security-based swap transaction appropriate? 87(c) Would an alternative definition more appropriately differentiate between U.S. and foreign counterparties for these purposes? 87(d) If so, what should that definition be?

Question 88(a). Is the proposed rule's definition of a foreign covered swap entity appropriate? 88(b) Would an alternative definition more appropriately differentiate between U.S. and foreign counterparties for these purposes? 88(c) If so, what should that definition be?

Question 89(a). Is the proposed rule's application of the margin requirements to all U.S. swaps and security-based swaps of a covered swap entity, regardless of whether that covered swap entity is U.S. or foreign, appropriate? 89(b) Should the proposed rule treat such transactions differently? 89(c) If so, how?

Question 90. What impact is the proposed rule's treatment of the swap and security-based swap transactions of foreign covered swap entities likely to have on the structure, management, and/or competitiveness of foreign covered swap entities?

J. Section __.10: Capital

The proposed rule generally requires a covered swap entity to comply with regulatory capital rules already made applicable to that covered swap entity as part of its prudential regulatory regime, as follows:

- In the case of insured depository institutions, the capital adequacy guidelines that are applicable to the covered entity and have been adopted by the appropriate Federal banking agency under section 38 of the Federal Deposit Insurance Act (12 U.S.C. 1831o);
- In the case of a bank holding company or savings and loan holding company (on or after the transfer established under Section 311 of the Dodd-Frank Act), the capital adequacy guidelines applicable to bank holding companies under the Board's Regulation Y (12 CFR part 225);
- In the case of a foreign bank or the U.S. branch or agency of a foreign bank, the capital rules that are made applicable to such covered entity pursuant to § 225.2(r)(3) of the Board's Regulation Y (12 CFR 225.2(r)(3);
- In the case of an Edge corporation or an Agreement corporation, the capital adequacy guidelines that are made applicable to an Edge corporation engaged in banking pursuant to § 211.12(c)(2) of the Board's Regulation K (12 CFR 211.12(c)(2);
- In the case of any "regulated entity" under the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (*i.e.,* Fannie Mae and its affiliates, Freddie Mac and its affiliates, and the Federal Home Loan Banks), the risk-based capital level or such other amount applicable to the covered swap entity as required by the Director of FHFA pursuant to 12 U.S.C. 4611;
- In the case of Farmer Mac, the capital adequacy regulations set forth in 12 CFR part 652; and
- In the case of any Farm Credit System institution (other than Farmer Mac), the capital regulations set forth in 12 CFR part 615.[86]

The Agencies have preliminarily determined that compliance with these regulatory capital requirements is sufficient to offset the greater risk to the swap entity and the financial system arising from the use of non-cleared swaps, helps ensure the safety and soundness of the covered swap entity, and is appropriate for the greater risk associated with the non-cleared swaps and non-cleared security-based swaps held as a covered swap entity. In particular, the Agencies note that the capital rules incorporated by reference into the proposed rule already address, in a risk-sensitive and comprehensive manner, the safety and soundness risks posed by a covered swap entity's derivatives positions.[87] In addition, the Agencies preliminarily believe that these capital rules sufficiently take into account and address the risks associated with the derivatives positions that a covered swap entity holds and the other activities conducted by a covered swap entity.[88]

The Agencies request comment regarding whether application of these capital regimes is appropriate.

Question 91. Is an alternative or additional capital requirement appropriate for some or all of the covered swap entities subject to the proposed rule?

Question 92. Are there particular issues or concerns raised in the context of foreign banks or their U.S. branches and agencies that would be better addressed through a different approach to the capital requirement for such entities?

K. Section __.11: Special Requirements for Transactions Between Swap Entities and Regulated Entities

FHFA and FCA (but not the other Agencies) are proposing an additional provision, § __.11 of FHFA's and FCA's proposed rules. Proposed § __.11 would require that any entity that is regulated by FHFA or FCA, but is not itself a covered swap entity, collect initial margin and variation margin from its counterparty when entering into a non-cleared swap or non-cleared security-based swap with a swap entity.[89] Regulated entities subject to this provision include the Federal Home Loan Banks, Fannie Mae and its affiliates, Freddie Mac and its affiliates, and all Farm Credit System institutions including Farmer Mac (collectively, regulated entities, and each a regulated entity). Regulated entities that are swap entities would be subject to §§ 1 through 9 of the proposed rule by virtue of being covered swap entities. This section also does not apply to swaps entered into between regulated entities and end users.

Proposed § __.11 is consistent with the risk-based approach to margin

[86] *See* proposed rule § __.10.

[87] For example, under the banking agencies' capital adequacy standards for banks and bank holding companies based on the first Basel Accord, interest-rate, exchange-rate, commodity, and equity-linked derivative contracts that are not traded on an exchange are subject to a capital charge based on type of contract, remaining maturity, and the risk category of the counterparty to the contract. *See* 12 CFR part 3, Appendix A § 3(b)(7) (OCC); 12 CFR parts 208 and 225, Appendix A § III.E (Board); 12 CFR part 325, Appendix A § II.E (FDIC). As another example, under the bank agencies' advanced risk-based capital adequacy standards based on the advanced approaches of the Basel II Accord ("advanced approaches"), banks and bank holding companies that use the advanced approaches determine capital requirements for over-the-counter derivatives based on a formula that takes into account collateral in mitigating counterparty credit risk. *See* 12 CFR part 3, Appendix C, part IV (OCC); 12 CFR part 208, Appendix F, part IV and 12 CFR part 225, Appendix G, part IV (Board); and 12 CFR part 325, Appendix D, part IV (FDIC). The FCA's capital requirements for FCS institutions other than Farmer Mac expressly address derivatives transactions. *See* 12 CFR 615.5201 and 615.5212. The FCA's capital requirements for Farmer Mac indirectly address derivatives transactions in the operational risk component of the statutorily mandated risk-based capital stress test model. *See* 12 CFR part 652 Subpart B Appendix A. The FCA, through the Office of Secondary Market Oversight, closely monitors and supervises all aspects of Farmer Mac's derivatives activities, and the FCA believes existing requirements and supervision are sufficient to ensure safe and sound operations in this area. However, the FCA is considering enhancements to the model and in the future may revise the model to more specifically address derivatives transactions.

[88] See footnote 33, *supra,* for a discussion of the basis for FHFA's preliminary view that the reference to existing statutory authority is sufficient to address the risks discussed in the text above as to the Enterprises notwithstanding their current conservatorship status.

[89] *See* FCA and FHFA proposed rule § __.11. FCA and FHFA note that in sections III.C and III.D of this notice of proposed rulemaking, the Agencies have requested comment on alternative approaches to margin requirements, including whether covered swap entities should be required to post margin to end users. In the event such an alternative approach is adopted as part of a final rule, as to both initial and variation margin requirements, FCA and FHFA note that this proposed § __.11 may not need to be adopted as part of that final rule.

proposed by the Agencies and parallels the requirements that swap entities collect initial and variation margin from their counterparties. Moreover, this approach recognizes that a default by a swap counterparty to a regulated entity could adversely affect the safe and sound operations of the regulated entity. The requirement reflects current practice in that the regulated entities generally obtain collateral to secure their swaps exposure to swap dealer counterparties, although current practice generally does not include posting of initial margin by or to any counterparty.

FHFA and FCA are proposing these provisions pursuant to each agency's role as safety and soundness regulator for its respective regulated entities, and each agency's authority to ensure that the regulated entities operate in a safe and sound manner, including that they maintain adequate capital and internal controls, that their activities foster liquid, efficient, competitive and resilient national finance markets for housing, agriculture, and rural markets, and that they carry out their public policy missions through authorized activities.[90]

Section __.11(a)(1) of the proposed rule requires a regulated entity to collect initial margin when it enters into a swap transaction with a swap entity. The proposal provides that the amount of initial margin the regulated entity must collect shall be in accordance with § __.3 of the proposed rule, which permits the use of either an initial margin model or the use of a standardized "look up" table specifying the minimum initial margin that must be collected as a percentage of the notional amount of the transaction. The minimum initial margin levels set out in Appendix A apply only in the absence of an initial margin model. FHFA and FCA, however, seek comment on whether a minimum initial margin requirement should apply as a backstop even to modeled initial margin amounts, as a prudent approach to address concerns about procyclicality and competitive pressures to reduce margin requirements. If not, how should such concerns be addressed?

Section __.11(a)(1) of the proposed rule permits a regulated entity to use its initial margin model to determine initial margin and provides that if the regulated entity does not have an initial margin model, it may engage a third party to calculate initial margin on its behalf, provided that the third party is itself independent of the swap entity that is the counterparty to the transaction. Any initial margin model used to determine margin posted to a regulated entity must meet all of the requirements of § __.8 of the proposed rule. FHFA and FCA preliminarily believe that permitting a swap entity to use its own model to calculate the amount of initial margin it would be required to post to a regulated entity may introduce a conflict of interest to the transaction. That concern could be addressed by establishing a process through which the regulated entity could verify the reasonableness of the counterparty's model calculation. FHFA and FCA each seeks comment on whether it should allow its regulated entities to use the counterparty's model to calculate initial margin, and if so, what provisions should be included to mitigate conflicts of interest.

Section __.11(a)(2) of the proposed rule requires that a regulated entity collect variation margin daily from the swap entity in accordance with the requirements of § __.4 of the proposed rule, which permits the amounts of variation margin posted to be adjusted to account for qualifying master netting agreements and applies a minimum transfer amount of $100,000.

Section __.11(b) of the proposed rule requires that any regulated entity entering into a non-cleared swap or a non-cleared security-based swap with a swap entity must execute trading documentation with such counterparty in accordance with § __.5 of the proposed rule. Section __.11(c) of the proposed rule provides that any collateral that a regulated entity is required to collect as initial or variation margin must meet the eligible collateral requirements of § __.6 of the proposed rule. That section applies the same eligibility requirements to the regulated entities that are required of the swap entities.

Section __.11(d) of the proposed rule provides that a regulated entity must require that any initial margin it posts to a counterparty be held by an independent custodian. That provision is consistent with the requirement in § __.7 of the proposed rule that a covered swap entity require segregation with an independent custodian of any initial margin that it posts to another swap entity. Section __.11(d) of the proposed rule applies this segregation requirement to variation margin as well as initial margin and thereby reflects current practice of at least some of the regulated entities. FHFA and FCA seek comments on whether such a requirement should be applied to variation margin and if it is not applied, how the regulated entities would be protected in the event variation margin is posted to a swap entity that subsequently fails.

IV. Quantitative Impact of Margin Requirements

The proposed rule would apply the initial margin and variation margin requirements to non-cleared swaps and security-based swaps that are entered into by a covered swap entity after the effective date, which is proposed to be 180 days after publication of a final rule in the **Federal Register**. The proposed rule would not require an immediate or retroactive application of initial margin or variation margin for any derivative transaction entered into prior to the effective date of the final rule.

Because the requirements would not be applied retroactively, no new initial margin or variation margin requirements would be imposed on derivatives transactions entered into prior to the effective date until such time as those transactions are rolled-over or renewed. The only requirements that would apply to a pre-effective date covered derivative would be the initial margin and variation margin requirements to which the parties to the transaction had previously agreed to by contract.

The new requirements will have an impact on the costs of engaging in new swap transactions. In particular, the proposed rule sets out requirements for initial and variation margin that represent a significant change from current industry practice in many circumstances. Assessing the quantitative impact of the proposed requirements is particularly difficult in light of the wide ranging and as yet undetermined changes that are occurring to the derivatives market as a result of regulatory reform. Specifically there is significant uncertainty with respect to (i) which entities would be classified as swap entities; (ii) the extent to which existing derivatives would be rolled-over or renewed; and (iii) the extent to which derivatives currently traded on an over-the-counter basis will move to central clearing by a CCP. In addition, there are a number of specific and technical aspects of the proposed rule, such as number and composition of counterparties that would be classified as high-risk financial end users, low-risk financial end users, and nonfinancial end users, respectively, that are difficult to assess without a large amount of highly detailed data on the size of derivative positions as well as the underlying rationale for maintaining those positions. These and other complicating factors make it difficult to make precise statements about the quantitative impact of the

[90] *See* 12 U.S.C. 2154, 2248, 2252, 4513, 4526.

margin rule specified under the proposed rule.

Accordingly, the Agencies request commenters to provide their own detailed quantitative impact analyses. The Agencies encourage commenters to include the following elements in their analyses categorized between swaps entities, high-risk financial end users, low-risk financial end users, and nonfinancial end users: (i) Required initial margin if internal models were applied; (ii) required initial margin if the standardized chart in Appendix A were applied; (iii) required variation margin; (iv) the expected costs of, or additional liquidity required by, the initial margin and variation margin requirements; and (v) the potential benefits of the initial margin and variation margin requirements to covered swap entities, their counterparties, and financial stability. The analyses should also (i) address operational and other business related costs associated with implementing the proposed rule and (ii) take into consideration and disclose the expected effect of the likely clearing of certain derivative transactions through CCPs in the future.

In order to better understand the effect that broader clearing requirements will have on the impact of the proposed rules, the Agencies also request comment on the levels of covered derivatives, including the roll-over or renewal of prior derivatives that would become covered under the proposed rule, that can be expected over the following time horizons after the effective date: (i) 1 year, (ii) 3 years, and (iii) 5 years. To maximize the usefulness of such comments, the Agencies request that commenters break down such projections by covered derivatives that are likely to be cleared and uncleared, as well as by product class.

V. Request for Comments

The Agencies are interested in receiving comments on all aspects of the proposed rule.

VI. Solicitation of Comments on Use of Plain Language

Section 722 of the Gramm-Leach-Bliley Act, Public Law 106–102, section 722, 113 Stat. 1338, 1471 (Nov. 12, 1999), requires the OCC, Board and FDIC to use plain language in all proposed and final rules published after January 1, 2000. The OCC, Board and FDIC invite your comments on how to make this proposal easier to understand. For example:

• Have we organized the material to suit your needs? If not, how could this material be better organized?

• Are the requirements in the proposed regulation clearly stated? If not, how could the regulation be more clearly stated?

• Does the proposed regulation contain language or jargon that is not clear? If so, which language requires clarification?

• Would a different format (grouping and order of sections, use of headings, paragraphing) make the regulation easier to understand? If so, what changes to the format would make the regulation easier to understand?

• What else could we do to make the regulation easier to understand?

VII. Administrative Law Matters

A. Paperwork Reduction Act Analysis

Request for Comment on Proposed Information Collection

Certain provisions of the proposed rule contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA"), 44 U.S.C. 3501–3521. In accordance with the requirements of the PRA, the Agencies may not conduct or sponsor, and the respondent is not required to respond to, an information collection unless it displays a currently valid Office of Management and Budget (OMB) control number. The information collection requirements contained in this joint notice of proposed rulemaking have been submitted by the FDIC, OCC, and FHFA to OMB for approval under section 3506 of the PRA and § 1320.11 of OMB's implementing regulations (5 CFR part 1320). The Board reviewed the proposed rule under the authority delegated to the Board by OMB.

Comments are invited on:

(a) Whether the collections of information are necessary for the proper performance of the agencies' functions, including whether the information has practical utility;

(b) The accuracy of the estimates of the burden of the information collections, including the validity of the methodology and assumptions used;

(c) Ways to enhance the quality, utility, and clarity of the information to be collected;

(d) Ways to minimize the burden of the information collections on respondents, including through the use of automated collection techniques or other forms of information technology; and

(e) Estimates of capital or start up costs and costs of operation, maintenance, and purchase of services to provide information.

All comments will become a matter of public record. Commenters may submit comments on aspects of this notice that may affect disclosure requirements and burden estimates at the addresses listed in the **ADDRESSES** section of this Supplementary Information. A copy of the comments may also be submitted to the OMB desk officer for the agencies: By mail to U.S. Office of Management and Budget, 725 17th Street, NW., #10235, Washington, DC 20503 or by facsimile (202–395–5806).

Title of Information Collection: Margin and Capital Requirements for Certain Swap Entities.

Frequency of Response: Event-generated and annual.

Affected Public: The affected public of the FDIC, OCC, and Board is assigned generally in accordance with the entities covered by the scope and authority section of their respective proposed rule. The affected public of FHFA generally would be those third parties not regulated by a prudential regulator that request prior written approval of an initial margin model for use by a regulated entity.

FDIC: Any FDIC-insured state-chartered bank that is not a member of the Federal Reserve System or FDIC-insured state-chartered savings association that is registered as a swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant.

OCC: Any national bank, Federal savings association, or Federal branch or agency of a foreign bank that is registered as a swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant.

Board: Any state member bank (as defined in 12 CFR 208.2(g)), bank holding company (as defined in 12 U.S.C. 1842), savings and loan holding company (as defined in 12 U.S.C. 1467a, (on or after the transfer established under Section 311 of the Dodd-Frank Act)12 U.S.C. 5411), foreign banking organization (as defined in 12 CFR 211.21(o)), state branch or state agency of a foreign bank (as defined in 12 U.S.C. 3101(b)(11) and (12)), or Edge or agreement corporation (as defined in 12 CFR 211.1(c)(2) and (3)) that is registered as a swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant.

FHFA: With respect to any regulated entity as defined in section 1303(20) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 U.S.C. 4502(20)), the proposed rule would not contain any collection of information pursuant to the PRA. However, the provisions in proposed § __.11(e) allowing a third party that is not subject to regulation by a prudential

regulator to request prior written approval of an initial margin model for use by a regulated entity, would be a collection of information under the PRA.

Abstract: The notice sets forth proposed margin and capital requirements with respect to non-cleared swaps and non-cleared security-based swaps for covered swap entities. The information requirements in joint regulations proposed by the Agencies are found in §§ __.2(t)(3), _.2(t)(4), _.4(e)(2)(i), __5, __.6(d)(2)(i), __.8(c)(1), __.8(c)(2), __8(c)(3), __8(d)(3), __8(d)(8), __.8(d)(9), __.8(d)(10), __.8(d)(12), __.8(e)(1), __.8(f)(2), __.8(f)(3), __.8(f)(4), and __.8(g). Compliance with the information collections found in sections __.2(t)(3) and _.2(t)(4) would be mandatory for any covered swap entity wishing to take a qualifying master netting agreement into account for purposes of calculating initial margin or variation margin. Compliance with the information collections found in §§ __.4(e)(2)(i), __.5, and _.6(d)(2)(i) would be mandatory for all covered swap entities. Compliance with the information collections found in §§ __.8(c)(1), __.8(c)(2), __.8(c)(3), __.8(d)(3), __.8(d)(8), __.8(d)(9), __.8(d)(10), __.8(d)(12), __.8(e)(1), __.8(f)(2), __.8(f)(3), __.8(f)(4), and __.8(g) would be mandatory for all covered swap entities wishing to use an initial margin model to calculate initial margin requirements.

In addition, § __.11(e) of FHFA's proposed rule contains an information collection that would be for all third parties that are not subject to regulation by a prudential regulator and that request prior written approval of an initial margin model for use by an FHFA-regulated entity.

Section-by-Section Analysis

Section _.2 defines terms used in the proposed rule, including the definition of "qualifying master netting agreement" contained in § __2(t). Sections __.2(t)(3) and __.2(t)(4) provide that, with respect to a qualifying master netting agreement, a covered swap entity must (i) conduct sufficient legal review of the agreement to conclude with a well-founded basis that the agreement meets specified criteria and (ii) establish and maintain procedures for monitoring relevant changes in law. The term "qualifying master netting agreement" is used elsewhere in the proposed rule to specify instances in which a covered swap entity may (i) calculate variation margin on an aggregate basis across multiple swaps and security-based swaps and (ii) calculate initial margin requirements under an initial margin model on a portfolio basis.

Section _.4 requires that on and after the date on which a covered swap entity enters into a non-cleared swap or non-cleared security-based swap, the covered swap entity shall collect variation margin from the counterparty to such swap or security-based swap in specified amounts. Section __.4(e)(2)(i) requires that, in cases where a counterparty refuses to provide required variation margin, a covered swap entity demonstrated upon request to the satisfaction of the relevant Agency that it has made appropriate efforts to collect the required variation margin unless it has otherwise made the necessary efforts to attempt to collect the required variation margin, including the timely initiation and continued pursuit of formal dispute resolution mechanisms.

Section __.5 requires a covered swap entity to execute trading documentation with each counterparty that (i) includes credit support arrangements that grant the covered swap entity the contractual right to collect initial margin and variation margin in such amounts, in such form, and such circumstances as are required by the initial margin and variation margin requirements set forth in the proposed rule and (ii) meets other specified criteria.

Section __.6 establishes certain forms of eligible collateral that a covered swap entity shall collect for initial margin and variation margin required pursuant to this part and requires a covered swap entity to monitor the market value of any eligible collateral it has collected to satisfy initial margin or variation margin required by this part and, to the extent that the market value of such collateral has declined, collect such additional eligible collateral as is necessary to bring itself into compliance with the margin requirements of this part. Section __.6(d)(2)(i) requires that, in cases where a counterparty refuses to provide required additional margin, a covered swap entity demonstrated upon request to the satisfaction of the relevant Agency that it has made appropriate efforts to collect the required additional margin unless it has otherwise made the necessary efforts to attempt to collect the required additional margin, including the timely initiation and continued pursuit of formal dispute resolution mechanisms.

Section __.8 establishes standards for initial margin models. These standards include:

- A requirement that the covered swap entity receive prior approval from the relevant Agency based on demonstration that the initial margin model meets specific requirements (§§ __.8(c)(1) and __.8(c)(2));
- A requirement that a covered swap entity notify the relevant Agency in writing before extending use of the model to additional product types, making certain changes to the initial margin model, or making material changes to modeling assumptions (§ __.8(c)(3));
- A variety of quantitative requirements, including requirements that the covered swap entity validate and demonstrate the reasonableness of its process for modeling and measuring hedging benefits, demonstrate to the satisfaction of the relevant Agency that the omission of any risk factor from the calculation of its initial margin is appropriate, demonstrate to the satisfaction of the relevant Agency that any conversion of initial margin calculated using a different holding period is appropriate, periodically review and, as necessary, revise the data used to calibrate the initial margin model to ensure that the data incorporate an appropriate period of significant financial stress (§§ __.8(d)(3), __.8(d)(8), __.8(d)(9), __.8(d)10), __.8(d)(12));
- A requirement that a covered swap entity review its initial margin model annually (§ __.8(e));
- A requirement that the covered swap entity validate its initial margin model initially and on an ongoing basis, describe to the relevant Agency any remedial actions being taken, and report internal audit findings regarding the effectiveness of the initial margin model to the covered swap entity's board of directors or a committee thereof (§§ __.8(f)(2), __.8(f)(3), and __.8(f)(4)); and
- A requirement that the covered swap entity adequately document all material aspects of its initial margin model (§ __.8(g)).

Section __.11(e) of FHFA's proposed rule applies § __.8 of the proposed rule, the information collection of which is described above, to any third party that is not subject to regulation by a prudential regulator and requests prior written approval of an initial margin model for use by an FHFA-regulated entity.

Estimated Paperwork Burden

Estimated Burden Per Response:

§ __.2—Definitions, § __.5—Documentation of margin matters, and § __.8(g)—Documentation: recordkeeping—5 hours.

§ __.4(e)(2)(i)—Variation margin and § __.6(d)(2)(i)—Eligible collateral: recordkeeping—4 hours.

§ __.8(c) and (d)—Initial margin model: reporting—240 hours.

§ __.8(e)—Periodic review and § __.8 (f)—Control, oversight and validation mechanisms: recordkeeping—40 hours.

§ __.11(e)—Special requirements for transactions between swap entities and regulated entities: Initial margin models: recordkeeping—220 hours.

FDIC

Number of Respondents: 3.

Total Estimated Annual Burden: 867 hours.

OCC

Number of Respondents: 20.

Total Estimated Annual Burden: 5,780 hours.

Board

Number of Respondents: 30.

Total Estimated Annual Burden: 8,670 hours.

FHFA

Number of Respondents: 2.

Total Estimated Annual Burden: 440 hours.

FCA: The FCA collects information from Farm Credit System institutions, which are Federal instrumentalities, in the FCA's capacity as their safety and soundness regulator, and, therefore, OMB approval is not required for this collection.

B. Initial Regulatory Flexibility Act Analysis

In accordance with section 3(a) of the Regulatory Flexibility Act, 5 U.S.C. 601 *et seq.* (RFA), the Agencies are publishing an initial regulatory flexibility analysis for the proposed rule. The RFA requires an agency to provide an initial regulatory flexibility analysis with the proposed rule or to certify that the proposed rule will not have a significant economic impact on a substantial number of small entities. The Agencies welcome comment on all aspects of the initial regulatory flexibility analysis. A final regulatory flexibility analysis will be conducted after consideration of comments received during the public comment period.

1. Statement of the objectives of the proposal. As required by section 4s of the Commodity Exchange Act (7 U.S.C. 6(s)) and section 15F of the Securities Exchange Act (15 U.S.C. 78*o*–8), the Agencies are proposing new regulations to establish rules imposing (i) capital requirements and (ii) initial and variation margin requirements on all non-cleared swaps into which the covered swap entities enter.

2. Small entities affected by the proposal. This proposal may have an effect predominantly on two types of small entities: (i) Financial institutions that are swap entities that are subject to the proposed rule's capital and margin requirements; and (ii) counterparties that engage in derivatives transactions with swap entities that are subject to the proposed rule's margin requirements.

With respect to financial institutions that are swap entities that are subject to the proposed rule's margin requirement, a financial institution generally is considered small if it has assets of $175 million or less.[91] Based on 2010 Call Report data, approximately 4,200 depository institutions had total domestic assets of $175 million or less. Of this number, however, the Agencies do not expect that any is likely to be a swap entity that is subject to the proposed rule's capital and margin requirements. With respect to counterparties that engage in derivatives transactions with swap entities that are subject to the proposed rule's margin requirements, the number of such counterparties and the extent to which certain types of companies are likely to be counterparties are unknown. However, of the 4,200 depository institutions described above, fewer than 250 are party to non-cleared derivative contracts.

3. Compliance requirements. With respect to the initial margin and variation margin requirements, the Agencies' proposed rule does not apply directly to counterparties that engage in derivatives transactions with swap entities. However, because the proposed rule requires a covered swap entity to collect a minimum amount of margin (subject to a threshold in some cases) from all counterparties, including small entities, the margin requirements may affect the amount of margin that counterparties that are small entities are required to post to dealer counterparties when transacting in the derivatives markets. Accordingly, the Agencies expect any economic impact on counterparties that are small entities to be negative to the extent that swap entities currently do not collect initial margin or variation margin from those counterparties but would be required to do so under the proposed rule.

4. Other Federal rules. The Agencies believe that no Federal rules duplicate, overlap, or conflict with the proposed rule.

5. Significant alternatives to the proposed rule. As discussed above, the Agencies have requested comment on the impact of the margin requirements on end users from which swap entities may be required to collect initial margin and/or variation margin and have solicited comment on any approaches that would reduce the burden on all counterparties, including small entities. In addition, the Agencies have proposed to reduce the effect of the proposed rule on counterparties to covered swap entities, including small entities, through the implementation of initial margin threshold amounts and variation margin threshold amounts. The Agencies have also requested comment on a variety of alternative approaches to implementing margin requirements with respect to swaps and security-based swaps with counterparties that are end users. The Agencies welcome comment on any significant alternatives that would minimize the impact of the proposal on small entities.

FCA: Pursuant to section 605(b) of the Regulatory Flexibility Act, 5 U.S.C. 601 *et seq.,* FCA hereby certifies that the proposed rule will not have a significant economic impact on a substantial number of small entities. Each of the banks in the Farm Credit System, considered together with its affiliated associations, has assets and annual income in excess of the amounts that would qualify them as small entities; nor does the Federal Agricultural Mortgage Corporation meet the definition of "small entity." Therefore, System institutions are not "small entities" as defined in the Regulatory Flexibility Act.

FHFA: FHFA believes that the proposed rule, if promulgated as a final rule, would not have a significant economic impact on a substantial number of small entities, since none of FHFA's regulated entities come within the meaning of small entities as defined in the Regulatory Flexibility Act (see 5 U.S.C. 601(6)), and would not substantially affect any business that its regulated entities might do with small entities.

C. OCC Unfunded Mandates Reform Act of 1995 Determination

Section 202 of the Unfunded Mandates Reform Act of 1995, Public Law 104–4 (Unfunded Mandates Act) requires that an agency prepare a budgetary impact statement before promulgating a rule that includes a Federal mandate that may result in expenditure by State, local, and tribal governments, in the aggregate, or by the private sector, of $100 million (adjusted for inflation) or more in any one year. The current inflation-adjusted expenditure threshold is $126.4 million. If a budgetary impact statement is

[91] U.S. Small Business Administration, Table of Small Business Size Standards Matched to North American Industry Classification System Codes, *available at http://www.sba.gov/sites/default/files/Size_Standards_Table.pdf.*

required, section 205 of the UMRA also requires an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule. The OCC has determined this proposed rule is likely to result in the expenditure by the private sector of $126.4 million or more. Therefore, the OCC has prepared a budgetary impact analysis and identified and considered alternative approaches. The full text of the OCC's analyses under the Unfunded Mandates Act is available at: *http://www.regulations.gov*, Docket ID OCC–2011–0008.

Text of the Proposed Common Rules (All Agencies)

The text of the proposed common rules appears below:

PART [ ]—MARGIN AND CAPITAL REQUIREMENTS FOR COVERED SWAP ENTITIES

__.1 Authority, purpose, and scope.
____.2 Definitions.
____.3 Initial margin.
____.4 Variation margin.
____.5 Documentation of margin matters.
____.6 Eligible collateral.
____.7 Segregation of collateral.
____.8 Initial margin models.
____.9 Application of margin requirements to certain foreign covered swap entities.
____.10 Capital.

Appendix A to Part [ ]—Standardized Minimum Initial Margin Requirements for Non-cleared Swaps and Non-cleared Security-based Swaps

Appendix B to Part [ ]—Margin Values for Noncash Collateral

§ ____.1 Authority, purpose, and scope. [Reserved]

§ ____.2 Definitions.

(a) *Clearing agency* has the meaning specified in section 3(a)(23) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(23)).

(b) *Counterparty* means, with respect to any swap or security-based swap to which a covered swap entity is a party, the counterparty to such swap or security-based swap, other than a counterparty that is a derivatives clearing organization or clearing agency.

(c) [Reserved]

(d) *Derivatives clearing organization* has the meaning specified in section 1a(15) of the Commodity Exchange Act (7 U.S.C. 1a(15)).

(e) *Eligible collateral* means collateral described in § ____.6.

(f) *Effective date* means [DATE THAT IS 180 DAYS AFTER PUBLICATION OF THE FINAL RULE IN THE FEDERAL REGISTER].

(g) *End user* means a counterparty that is not a swap entity.

(h) *Financial end user* means any counterparty that is an end user that is—

(1) A commodity pool as defined in section 1a(5) of the Commodity Exchange Act (7 U.S.C. 1a(5));

(2) A private fund as defined in section 202(a) of the Investment Advisors Act of 1940 (15 U.S.C. 80–b–2(a));

(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 (29 U.S.C. 1002);

(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 of 1956 (12 U.S.C. 1843(k));

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

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

(7) Any other person that [Agency] may designate.

(i) *High-risk financial end user* means a counterparty that is a financial end user but is not a low-risk financial end user.

(j) *Initial margin* means eligible collateral that is pledged in connection with entering into a swap or security-based swap by a party thereto to secure the performance of its obligations to its counterparty under one or more swaps or security-based swaps.

(k) *Initial margin collection amount* means—

(1) In the case of a covered swap entity that does not have an initial margin model, the amount of initial margin with respect to a swap or security-based swap that is required under Appendix A of this part; and

(2) In the case of a covered swap entity that does have an initial margin model, the amount of initial margin with respect to a swap or security-based swap that is required under the initial margin model.

(l) *Initial margin model* means an internal risk management model that—

(1) Has been developed and designed to identify an appropriate, risk-based amount of initial margin that the covered swap entity must collect with respect to one or more swaps or security-based swaps to which the covered swap entity is a party; and

(2) Has been approved by [Agency] pursuant to § ____.8 of this part.

(m) *Initial margin threshold amount* means a credit exposure limit that has been established by a covered swap entity with respect to its swaps and security-based swaps with a counterparty, that appropriately takes into account and addresses the credit risk posed by the counterparty and the risks of such swaps and security-based swaps, and that has been reviewed, monitored and approved in accordance with the covered swap entity's credit processes, except that in no case shall the threshold amount be greater than—

(1) Zero, if the counterparty is either a swap entity or a high-risk financial end user; or

(2) The lesser of [$15 to $45] million and [0.1 to 0.3] percent of the covered swap entity's [capital metric], if the counterparty is a low-risk financial end user.

(n) *Low-risk financial end user* means a counterparty that is a financial end user and makes the following representations to a covered swap entity in connection with entering into a swap or security-based swap with the covered swap entity—

(1) The counterparty does not have a significant swaps exposure;

(2) The counterparty predominantly uses swaps or security-based swaps to hedge or mitigate the risks of its business activities, including balance sheet, interest rate, or other risk arising from the business of the counterparty; and

(3) The counterparty is subject to capital requirements established by a prudential regulator or state insurance regulator.

(o) *Margin* means initial margin and variation margin.

(p) *Non-cleared swap* means a swap that is not a cleared swap, as that term is defined in section 1a(7) of the Commodity Exchange Act (7 U.S.C. 1a(7)).

(q) *Non-cleared security-based swap* means a security-based swap that is not, directly or indirectly, submitted to and cleared by a clearing agency registered with the SEC.

(r) *Nonfinancial end user* means any counterparty that is an end user but is not a financial end user.

(s) *Prudential regulator* has the meaning specified in section 1a(39) of the Commodity Exchange Act (7 U.S.C. 1a(39)).

(t) *Qualifying master netting agreement* means an agreement governing one or more swaps or security-based swaps to which a covered swap entity is a party that satisfies the following criteria—

(1) The agreement creates a single legal obligation for all individual

transactions covered by the agreement upon an event of default, including bankruptcy, insolvency, or similar proceeding, of the counterparty;

(2) The agreement provides the covered swap entity the right to accelerate, terminate, and close-out on a net basis all transactions under the agreement and to liquidate or set off collateral promptly upon an event of default, including upon an event of bankruptcy, insolvency, or similar proceeding, of the counterparty, provided that, in any such case, any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions;

(3) The covered swap entity has conducted sufficient legal review to conclude with a well-founded basis (and maintains sufficient written documentation of that legal review) that—

(i) The agreement meets the requirements of paragraph (t)(2) of this definition; and

(ii) In the event of a legal challenge (including one resulting from default or from bankruptcy, insolvency, or similar proceeding) the relevant court and administrative authorities would find the agreement to be legal, valid, binding, and enforceable under the law of the relevant jurisdictions;

(4) The covered swap entity establishes and maintains procedures to monitor possible changes in relevant law and to ensure that the agreement continues to satisfy the requirements of this definition; and

(5) The agreement does not contain a provision that permits a non-defaulting counterparty to make a lower payment than it would make otherwise under the agreement, or no payment at all, to a defaulter or the estate of a defaulter, even if the defaulter or the estate of the defaulter is a net creditor under the agreement.

(u) *Security-based swap* has the meaning specified in section 3(a)(68) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(68)).

(v) *Significant swaps exposure* means—

(1) Swap positions that equal or exceed any 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; or

(2) Security-based swap positions that equal or exceed any of the following thresholds—

(i) $1 billion in daily average aggregate uncollateralized outward exposure; or

(ii) $2 billion in daily average aggregate uncollateralized outward exposure plus daily average aggregate potential outward exposure.

(3) For purposes of this definition—

(i) The terms *daily average aggregate uncollateralized outward exposure* and *daily average aggregate potential outward exposure,* when used with respect to swaps, each has the meaning specified for that term in [17 CFR 1.3(uuu)] for purposes of calculating substantial counterparty exposure under that regulation.

(ii) The terms *daily average aggregate uncollateralized outward exposure* and *daily average aggregate potential outward exposure,* when used with respect to security-based swaps, each has the meaning specified for that term in [15 CFR 240.3a67–5] for purposes of calculating substantial counterparty exposure under that regulation.

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

(x) *Swap* has the meaning specified in section 1a(47) of the Commodity Exchange Act (7 U.S.C. 1a(47)).

(y) *Swap entity* means a security-based swap dealer as defined in section 3(a)(71) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(71)), a major security-based swap participant as defined in section 3(a)(67) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(67)), a swap dealer as defined in section 1a(49) of the Commodity Exchange Act (7 U.S.C. 1a(49)), or a major swap participant as defined in section 1a(33) of the Commodity Exchange Act (7 U.S.C. 1a(33)).

(z) *Variation margin* means eligible collateral pledged or paid on an intraday, daily or other periodic basis by one party to a swap or security-based swap to its counterparty to offset a change in the value of one or more swaps or security-based swaps between the parties, as calculated in accordance with the contractual terms of such swaps or security-based swaps.

(aa) *Variation margin amount* means the cumulative mark-to-market change in value to a covered swap entity of a swap or security-based swap, as measured from the date it is entered into (or, in the case of swap or security-based swap that has a current positive or negative value to a covered swap entity on the date it is entered into, such positive or negative value plus any cumulative mark-to-market change in value to the covered swap entity of a swap or security-based swap after such date), less the value of all variation margin previously collected but not returned by the covered swap entity (expressed as a positive amount) with respect to such swap or security-based swap.

(bb) *Variation margin threshold amount* means a credit exposure limit that has been established by a covered swap entity with respect to its swaps and security-based swaps with a counterparty, that appropriately takes into account and addresses the credit risk posed by the counterparty and the risks of such swaps and security-based swaps, and that has been reviewed, monitored and approved in accordance with the covered swap entity's credit processes, except that in no case shall the threshold amount be greater than—

(1) Zero, if the counterparty is a either a swap entity or a high-risk financial end user; or

(2) The lesser of [$15 to 45] million and [0.1 to 0.3]% of the covered swap entity's [capital metric], if the counterparty is a low-risk financial end user.

§ __.3 Initial margin.

(a) *General.* A covered swap entity shall collect initial margin with respect to any non-cleared swap or non-cleared security-based swap from the counterparty to such swap or security-based swap in an amount that is no less than the greater of—

(1) Zero; or

(2) The initial margin collection amount for such swap or security-based swap *less* the initial margin threshold amount for the counterparty (not including any portion of the initial margin threshold amount being applied to other swaps or security-based swaps with the counterparty), as applicable.

(b) *Timing.* A covered swap entity shall, with respect to any non-cleared swap or non-cleared security-based swap to which it is a party, comply with the initial margin requirements described in paragraph (a) for a period beginning on or before the date it enters into such swap or security-based swap and ending on the date the non-cleared swap or non-cleared security-based swap is terminated or expires.

(c) *Minimum Transfer Amount.* Notwithstanding anything else in this section, a covered swap entity is not required to collect initial margin pursuant to this section with respect to a particular counterparty unless and until the total amount of initial margin that is required pursuant to this section to be collected, but has not yet been collected, with respect to the counterparty is greater than $100,000.

§ __.4 Variation margin.

(a) *General.* On and after the date on which a covered swap entity enters into a non-cleared swap or non-cleared security-based swap, the covered swap entity shall, to the extent the variation margin amount for such swap or security-based swap is positive, collect variation margin from the counterparty to such swap or security-based swap in an amount that is no less than the greater of—

(1) Zero; or

(2) The variation margin amount for such swap or security-based swap *less* the variation margin threshold amount for the counterparty (not including any portion of the variation margin threshold amount being applied to other swaps or security-based swaps with the counterparty), as applicable.

(b) *Frequency.* A covered swap entity shall comply with the variation margin requirements described in paragraph (a) of this section—

(1) No less than once per business day with respect to a counterparty that is a swap entity or a financial end user; and

(2) No less than once per week with respect to a counterparty that is a nonfinancial end user.

(c) *Minimum transfer amount.* Notwithstanding anything else in this section, a covered swap entity is not required to collect variation margin pursuant to this section unless and until the total amount of variation margin that is required pursuant to this section to be collected, but has not yet been collected, with respect to the counterparty is greater than $100,000.

(d) *Netting arrangements.* To the extent that one or more non-cleared swaps or non-cleared security-based swaps are executed pursuant to a qualifying master netting agreement 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 swaps and security-based swaps governed by such agreement, so long as the covered swap entity complies with these variation margin requirements with respect to all swaps and security-based swaps governed by such agreement regardless of whether the swaps and security-based swaps were entered into on or after the effective date.

(e) A covered swap entity shall not be deemed to have violated its obligation under paragraph (a) of this section to collect variation margin from a counterparty if—

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

(2) The covered swap entity has—

(i) 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 [Agency] that it has made appropriate efforts to collect the required variation margin; or

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

§ __.5 Documentation of margin matters.

A covered swap entity shall execute trading documentation with each counterparty regarding credit support arrangements that—

(a) Provides the covered swap entity with the contractual right to collect initial margin and variation margin in such amounts, in such form, and under such circumstances as are required by this part; and

(b) Specifies—

(1) The methods, procedures, rules, and inputs for determining the value of each swap or security-based swap for purposes of calculating variation margin requirements; and

(2) The procedures by which any disputes concerning the valuation of swaps or security-based swaps, or the valuation of assets collected or posted as initial margin or variation margin, may be resolved.

§ __.6 Eligible collateral.

(a) A covered swap entity shall collect initial margin and variation margin required pursuant to this part solely in the form of one or more of the following types of eligible collateral—

(1) Immediately available cash funds that are denominated in—

(i) U.S. dollars; or

(ii) The currency in which payment obligations under the swap are required to be settled;

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

(3) With respect to initial margin only—

(i) Any senior debt obligation of the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, the Federal Home Loan Banks and the Federal Agricultural Mortgage Corporation; and

(ii) 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.

(b) The value of any eligible collateral described in paragraphs (a)(2) or (a)(3) of this section, for purposes of satisfying the initial margin or variation margin requirements of this part shall be subject to, and limited by, the discounts described in Appendix B of this part.

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

(d) A covered swap entity shall monitor the market value of any eligible collateral it has collected to satisfy initial margin or variation margin required by this part and, to the extent that the market value of such collateral has declined, shall collect such additional eligible collateral as is necessary to bring itself into compliance with the margin requirements of this part. A covered swap entity shall not be deemed to have violated its obligation under this paragraph (d) to collect additional eligible collateral from a counterparty if—

(1) The counterparty has refused or otherwise failed to provide the required additional eligible collateral to the covered swap entity; and

(2) The covered swap entity—

(i) Has made the necessary efforts to attempt to collect the required additional eligible collateral, including the timely initiation and continued pursuit of formal dispute resolution mechanisms, or has otherwise demonstrated upon request to the satisfaction of [Agency] that it has made appropriate efforts to collect the required additional eligible collateral; or

(ii) Has commenced termination of the swap or security-based swap with the counterparty.

(e) A covered swap entity may collect initial margin and variation margin that is not required pursuant to this part in any form of collateral.

§ __.7 Segregation of collateral.

A covered swap entity that enters into a non-cleared swap or non-cleared security-based swap with a swap entity and posts initial margin to the swap entity with respect to that swap or security-based swap shall require that—

(a) All funds or other property the covered swap entity provides as initial margin are held by a third-party custodian that is independent of the covered swap entity and the counterparty;

(b) The independent custodian is prohibited by contract from rehypothecating or otherwise transferring any initial margin held by the custodian;

(c) The independent custodian is prohibited by contract from reinvesting any initial margin held by the custodian

in any asset that would not qualify as eligible collateral under § __.6 for purposes of satisfying the initial margin requirements of this part; and

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

§ __.8 Initial margin models.

(a) *General adequacy of initial margin model.* Unless a covered swap entity's initial margin model conforms to the requirements of this section, the covered swap entity shall calculate all initial margin collection amounts pursuant to Appendix A of this part.

(b) *Applicability to swaps and security-based swaps.* Any initial margin model that a covered swap entity wishes to use to calculate the amount of initial margin required to be collected for a single swap or security-based swap transaction or a portfolio of swap and/or security-based swap transactions with a given counterparty pursuant to § __.3 must meet each requirement of this section. An initial margin model may be designed to calculate initial margin for a portfolio of swaps and/or security-based swaps only if all such swaps and/or security-based swaps are governed by the same qualifying master netting agreement. To the extent that a qualifying master netting agreement between a covered swap entity and its counterparty governs swaps or security-based swaps that were entered into before, on, and after the effective date, the covered swap entity may use its initial margin model to calculate the amount of initial margin required to be collected pursuant to § __.3 either—

(1) With respect to only those swaps and/or security-based swaps transactions entered into on and after the effective date; or

(2) With respect to all swaps and/or security-based swaps transactions governed by such qualifying master netting agreement, regardless of whether they were entered into before, on, or after the effective date.

(c) *Requirements for initial margin model.*

(1) A covered swap entity must obtain the prior written approval of [Agency] before using any initial margin model to calculate the initial margin required in this part.

(2) A covered swap entity must demonstrate that the initial margin model satisfies all of the requirements of this section on an ongoing basis.

(3) A covered swap entity must promptly notify [Agency] in writing prior to:

(i) Extending the use of an initial margin model that [Agency] has approved under this section to an additional product type;

(ii) Making any change to any initial margin model approved by [Agency] under this section that would result in a material change in the covered swap entity's assessment of initial margin requirements; or

(iii) Making any material change to modeling assumptions used by the initial margin model.

(4) [The Agency] may rescind its approval of the use of any initial margin model, in whole or in part, or may impose additional conditions or requirements if [Agency] determines that the initial margin model no longer complies with this section.

(d) *Quantitative requirements.*

(1) The covered entity's initial margin model must calculate an amount of initial margin that is equal to the potential future exposure of the swap, security-based swap or portfolio of swaps and/or security-based swaps. Potential future exposure is an estimate of the one-tailed 99 percent confidence interval for an increase in the value of the swap, security-based swap or portfolio of swaps and/or security-based swaps due to an instantaneous price shock that is equivalent to a movement in all material underlying risk factors, including prices, rates, and spreads, over a holding period equal to the shorter of ten business days or the maturity of the swap or security-based swap. If a covered swap entity elects to calculate initial margin using an initial margin model on a portfolio of swaps and/or security-based swaps under the same qualifying master netting agreement, the covered entity must calculate an amount of initial margin for that portfolio each time a new swap or security-based swap is added to that portfolio and collect any incremental initial margin collection amount that is required.

(2) The covered swap entity's initial margin model must use risk factors sufficient to measure all material price risks inherent in the swap transactions for which initial margin is being calculated. The risk categories must include, but should not be limited to, foreign exchange/interest rate risk, credit risk, equity risk, and commodity risk, as appropriate. For material exposures in the major currencies and markets, modeling techniques must capture spread and basis risk and must incorporate a sufficient number of segments of the yield curve to capture differences in volatility and imperfect correlation of rates along the yield curve.

(3) The initial margin model may calculate initial margin for a portfolio of swaps and/or security-based swaps and reflect offsetting exposures, diversification, and other hedging benefits for swaps and security-based swaps that are governed by the same qualifying master netting agreement by incorporating empirical correlations within the following four broad risk categories, provided the covered swap entity validates and demonstrates the reasonableness of its process for modeling and measuring hedging benefits: Commodity, credit, equity, and foreign exchange/interest rate. Offsetting exposures, diversification, and other hedging benefits under a qualifying master netting agreement may be recognized by the initial margin model within each broad risk category, but not across broad risk categories.

(4) If the initial margin model does not explicitly reflect offsetting exposures, diversification, and hedging benefits within a broad risk category, the covered swap entity must calculate an amount of initial margin separately for each subset of swaps and security-based swaps for which offsetting exposures, diversification, and other hedging benefits are explicitly recognized by the initial margin model. The sum of the initial margin amounts calculated for each subset of swaps and security-based swaps within a broad risk category will be used to determine the aggregate initial margin due from the counterparty for the portfolio of swaps and security-based swaps within the broad risk category.

(5) The sum of the initial margins calculated for each broad risk category will be used to determine the aggregate initial margin due from the counterparty.

(6) The initial margin model may not permit the calculation of any initial margin collection amount to be subject to offset by, or otherwise take into account, any initial margin that may be owed or otherwise payable by the covered swap entity to the counterparty.

(7) The initial margin model must include all material risks arising from the nonlinear price characteristics of options positions or positions with embedded optionality and the sensitivity of the market value of the positions to changes in the volatility of the underlying rates, prices, or other material risk factors. As an example, a covered swap entity with a large or complex options portfolio must measure the volatility of options positions or positions with embedded optionality by different maturities and/or strike prices, where material.

(8) The covered swap entity may not omit any risk factor from the calculation of its initial margin that the covered swap entity uses in its initial margin model unless it has previously demonstrated to the satisfaction of [Agency] that such omission is appropriate.

(9) The covered swap entity may not incorporate any proxy or approximation used to capture the risks of the covered swap entity's actual swap or security-based swap transactions unless it has previously demonstrated to the satisfaction of [Agency] that such proxy or approximation is appropriate.

(10) The covered swap entity may calculate initial margin over the holding period directly or it may convert an initial margin calculated using a different holding period. A covered swap entity may not convert its initial margin calculation in such a manner unless it has previously demonstrated to the satisfaction of [Agency] that such conversion is appropriate.

(11) All data used to calibrate the initial margin model must be based on a historical observation period of at least one year and must incorporate a period of significant financial stress appropriate to the swap and/or security-based swap transactions to which the initial margin model is applied.

(12) The covered swap entity must review and, as necessary, revise the data used to calibrate the initial margin model at least monthly, and more frequently as market conditions warrant, to ensure that the data incorporate a period of significant financial stress appropriate to the swap and/or security-based swap transactions to which the initial margin model is applied.

(13) The level of sophistication of the initial margin model must be commensurate with the complexity of the swap and/or security-based swap transactions to which they are applied. In calculating an initial margin collection amount, the initial margin model may make use of any of the generally accepted approaches for modeling the risk of a single instrument or portfolio of instruments.

(14) The covered swap entity must periodically benchmark the initial margin model against observable margin standards to ensure that the initial margin required is not less than what a derivatives clearing organization or a clearing agency would require for similar transactions.

(15) [The Agency] may require a covered swap entity using an initial margin model to collect a greater amount of initial margin than that determined by the covered swap entity's initial margin model.

(e) *Periodic review.* A covered swap entity must periodically, but no less frequently than annually, review its initial margin model in light of developments in financial markets and modeling technologies, and enhance the initial margin model as appropriate to ensure that the initial margin model continues to meet the requirements for approval in this section.

(f) *Control, oversight, and validation mechanisms.*

(1) The covered swap entity must have a risk control unit that reports directly to senior management and is independent from the business trading units.

(2) The covered swap entity must validate its initial margin model initially and on an ongoing basis. The covered swap entity's validation process must be independent of the development, implementation, and operation of the initial margin model, or the validation process must be subjected to an independent review of its adequacy and effectiveness. The validation process must include:

(i) An evaluation of the conceptual soundness of (including developmental evidence supporting) the initial margin model;

(i) An ongoing monitoring process that includes verification of processes and benchmarking by comparing the covered swap entity's initial margin model outputs (estimation of initial margin) with relevant alternative internal and external data sources or estimation techniques; and

(ii) An outcomes analysis process that includes backtesting of the initial margin model.

(3) If the validation process reveals any significant problems with the initial margin model, the covered swap entity must notify [Agency] of the problems, describe to [Agency] any remedial actions being taken, and adjust the initial margin model to insure an appropriately conservative amount of required initial margin is being calculated.

(4) The covered swap entity must have an internal audit function independent of business-line management that at least annually assesses the effectiveness of the controls supporting the covered swap entity's initial margin model measurement systems, including the activities of the business trading units and independent risk control unit, compliance with policies and procedures, and calculation of the covered swap entity's initial margin requirements under this part. At least annually, the internal audit function must report its findings to the covered swap entity's board of directors or a committee thereof.

(g) *Documentation.* The covered swap entity must adequately document all material aspects of its initial margin model, including management and valuation of swap and/or security-based swap transactions to which they apply, the control, oversight, and validation of the initial margin model, any review processes and the results of such processes.

§ __.9 Application of margin requirements to certain foreign covered swap entities.

(a) The requirements of §§ __.3 through __.8 shall not apply to any foreign non-cleared swap or foreign non-cleared security-based swap of a foreign covered swap entity.

(b) For purposes of this section, a *foreign non-cleared swap or foreign non-cleared security-based swap* is any non-cleared swap or non-cleared security-based swap transaction with respect to which—

(1) The counterparty to the foreign covered swap entity is—

(i) Not an entity organized under the laws of the United States or any State;

(ii) Not a branch or office of an entity organized under the laws of the United States or any State; and

(iii) Not a person resident in the United States; and

(2) Performance of the counterparty's obligations to the foreign covered swap entity under the swap or security-based swap has not been guaranteed by an affiliate of the counterparty that is—

(i) An entity organized under the laws of the United States or any State;

(ii) A branch or office of an entity organized under the laws of the United States or any State; or

(iii) A person resident in the United States.

(c) For purposes of this section, a *foreign covered swap entity* is any covered swap entity that is—

(1) Not a company organized under the laws of the United States or any State;

(2) Not a branch or office of a company organized under the laws of the United States or any State;

(3) Not a U.S. branch, agency or subsidiary of a foreign bank; and

(4) Not controlled, directly or indirectly, by a company that is organized under the laws of the United States or any State.

§ __.10 Capital.

[Reserved]

Appendix A to Part [ ]—Standardized Minimum Initial Margin Requirements for Non-cleared Swaps and Non-cleared Security-based Swaps.

STANDARDIZED MINIMUM INITIAL MARGIN REQUIREMENTS FOR NON-CLEARED SWAPS AND NON-CLEARED SECURITY-BASED SWAPS

Asset Class	Initial margin requirement (% of notional exposure)
Credit: 0–2 year duration	[1–3]
Credit: 2–5 year duration	[2–8]
Credit: 5+ year duration	[5–15]
Commodity	[10–20]
Equity	[10–20]
Foreign Exchange/Currency	[3–9]
Interest Rate: 0–2 year duration.	[0–2]
Interest Rate: 2–5 year duration.	[1–3]
Interest rate: 5+ year duration	[2–6]
Other	[10–20]

Appendix B to Part [ ]—Margin Values for Noncash Collateral.

MARGIN VALUES FOR NONCASH COLLATERAL

	Margin value (% 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]
Senior Debt Obligations of FHFA Regulated Entities and the Federal Agricultural Mortgage Corporation, and Insured Obligations of Farm Credit System Banks:			
Bills/Notes/Bonds	[96–100]	[94–98]	[93–97]
Zero Coupon	[95–99]	[93–97]	[89–93]

[END OF COMMON TEXT]

Adoption of the Common Rule Text

The proposed adoption of the common rules by the agencies, as modified by agency-specific text, is set forth below:

DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

List of Subjects in 12 CFR Part 45

12 CFR Chapter I

Administrative practice and procedure, Capital, Margin requirements, National banks, Reporting and recordkeeping requirements, Risk.

Authority and Issuance

For the reasons stated in the Common Preamble, the Office of the Comptroller of the Currency proposes to amend chapter I of Title 12, Code of Federal Regulations as follows:

PART 45—MARGIN AND CAPITAL REQUIREMENTS FOR COVERED SWAP ENTITIES

1. The authority citation for part 45 is added to read as follows:

Authority: 7 U.S.C. 6s(e), 12 U.S.C. 1 *et seq.,* 93a, 161, 1818, 3907, 3090, and 15 U.S.C. 78o–10(e).

2. Part 45 is added as set forth at the end of the Common Preamble.

3. Part 45 is amended by:

a. Removing "[Agency]" wherever it appears and adding in its place "the OCC";

b. Removing "[The Agency]" wherever it appears and adding in its place "The OCC"; and

c. Removing "[capital metric]" wherever it appears and adding in its place "Tier 1 capital".

4. Section 45.1 is added to read as follows:

§ 45.1 Authority, purpose, and scope.

(a) *Authority.* This part is issued under the authority of 7 U.S.C. 6s(e), 12 U.S.C. 1 *et seq.,* 93a, 161, 1818, 3907, 3090, and 15 U.S.C. 78o–10(e).

(b) *Purpose.* Section 4s of the Commodity Exchange Act (7 U.S.C. 6s) and section 15F of the Securities Exchange Act of 1934 (15 U.S.C. 78*o*–8) require the OCC to establish capital and margin requirements for any national bank, Federal savings association, or Federal branch or agency of a foreign banks that is registered as a swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant with respect to all non-cleared swaps and non-cleared security-based swaps. This regulation implements section 4s of the Commodity Exchange Act and section 15F of the Securities Exchange Act of 1934 by defining terms used in the statute and related terms, establishing capital and margin requirements, and explaining the statutes' requirements.

(c) *Scope.* This part establishes minimum capital and margin requirements for each covered swap entity subject to this part with respect to all non-cleared swaps and non-cleared security-based swaps. This part applies to any non-cleared swap or non-cleared security-based swap entered into by a covered swap entity on or after [INSERT DATE THAT IS 180 DAYS AFTER PUBLICATION OF THE FINAL RULE IN THE FEDERAL REGISTER]. Nothing in this part is intended to prevent a covered swap entity from collecting margin in amounts greater than are required under this part.

5. Paragraph (c) of § 45.2 is added to read as follows:

§ 45.2 Definitions.

* * * * *

(c) *Covered swap entity* means any national bank, Federal savings association, or Federal branch and agency of a foreign bank that is a swap

entity, or any other entity that the OCC determines.

* * * * *

6. Section 45.10 is added to read as follows:

§ 45.10 Capital.

A covered swap entity shall comply with:

(a) In the case of a covered swap entity that is a national bank, the minimum capital requirements in 12 CFR part 3;

(b) In the case of a covered swap entity that is a Federal savings association, the minimum capital requirements in 12 CFR part 567; and

(c) In the case of a covered swap entity that is a Federal branch or agency of a foreign bank, the capital adequacy guidelines that are applicable as generally provided under 12 CFR 28.14.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

List of Subjects in 12 CFR Part 237

12 CFR Chapter II

Administrative practice and procedure, Banks and banking, Capital, Foreign banking, Holding companies, Margin requirements, Reporting and recordkeeping requirements, Risk.

Authority and Issuance

For the reasons set forth in the Supplementary Information, the Board of Governors of the Federal Reserve System proposes to add the text of the common rule as set forth at the end of the Supplementary Information as part 237 to 12 CFR chapter II as follows:

PART 237—MARGIN AND CAPITAL REQUIREMENTS FOR COVERED SWAP ENTITIES (REGULATION KK)

7. The authority citation for part 237 is added to read as follows:

Authority: 7 U.S.C. 6s(e), 15 U.S.C. 78o–10(e), 12 U.S.C. 221 *et seq.,* 12 U.S.C. 1818, 12 U.S.C. 1841 *et seq.,* and 12 U.S.C. 3103 *et seq.*

8. Part 237 is added as set forth at the end of the Common Preamble.

9. Part 237 is amended by:

a. Removing "[Agency]" wherever it appears and adding in its place "the Board";

b. Removing "[The Agency]" wherever it appears and adding in its place "The Board"; and

c. Removing "[capital metric]" wherever it appears and adding in its place "tier 1 capital".

10. Section 237.1 is added to read as follows:

§ 237.1 Authority, purpose, and scope.

(a) *Authority.* This part (Regulation KK) is issued by the Board of Governors of the Federal Reserve System (Board) under section 4s(e) of the Commodity Exchange Act (7 U.S.C. 6s(e)) and section 15F(e) of the Securities Exchange Act of 1934 (15 U.S.C. 78o–10(e)), as well as under the Federal Reserve Act, as amended (12 U.S.C. 221 *et seq.*); section 8 of the Federal Deposit Insurance Act, as amended (12 U.S.C. 1818); the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1841 *et seq.*); and the International Banking Act of 1978, as amended (12 U.S.C. 3101 *et seq.*).

(b) *Purpose.* Section 4s of the Commodity Exchange Act (7 U.S.C. 6s) and section 15F of the Securities Exchange Act of 1934 (15 U.S.C. 78*o*–8) require the Board to establish capital and margin requirements for any state member bank (as defined in 12 CFR 208.2(g)), bank holding company (as defined in 12 U.S.C. 1842), savings and loan holding company (as defined in 12 U.S.C. 1467a (on or after the transfer established under Section 311 of the Dodd-Frank Act) 12 U.S.C. 5411)), foreign banking organization (as defined in 12 CFR 211.21(o)), state branch or state agency of a foreign bank (as defined in 12 U.S.C. 3101(b)(11) and (12)), or Edge or agreement corporation (as defined in 12 CFR 211.1(c)(2) and (3)) that is registered as a swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant with respect to all non-cleared swaps and non-cleared security-based swaps. This regulation implements section 4s of the Commodity Exchange Act and section 15F of the Securities Exchange Act of 1934 by defining terms used in the statute and related terms, establishing capital and margin requirements, and explaining the statutes' requirements.

(c) *Scope.* This part establishes minimum capital and margin requirements for each covered swap entity subject to this part with respect to all non-cleared swaps and non-cleared security-based swaps. This part applies to any non-cleared swap or non-cleared security-based swap entered into by a covered swap entity on or after [INSERT DATE THAT IS 180 DAYS AFTER PUBLICATION OF THE FINAL RULE IN THE FEDERAL REGISTER]. Nothing in this part is intended to prevent a covered swap entity from collecting margin in amounts greater than are required under this part.

11. Paragraph (c) of § 237.2 is added to read as follows:

§ 237.2 Definitions.

* * * * *

(c) *Covered swap entity* means any state member bank (as defined in 12 CFR 208.2(g)), bank holding company (as defined in 12 U.S.C. 1842), savings and loan holding company (as defined in 12 U.S.C. 1467a (on or after the transfer established under Section 311 of the Dodd-Frank Act) 12 U.S.C. 5411)), foreign banking organization (as defined in 12 CFR 211.21(o)), any state branch or state agency of a foreign bank (as defined in 12 U.S.C. 3101(b)(11) and (12)), or Edge or agreement corporation (as defined in 12 CFR 211.1(c)(2) and (3)) that is a swap entity, or any other entity that the Board determines.

* * * * *

12. Section 237.10 is added to read as follows:

§ 237.10 Capital.

A covered swap entity shall comply with:

(a) In the case of a covered swap entity that is a state member bank (as defined in 12 CFR 208.2(g)), the capital adequacy guidelines that are applicable to the covered swap entity and have been adopted by the Board under section 38 of the Federal Deposit Insurance Act (12 U.S.C. 1831o);

(b) In the case of a covered swap entity that is a bank holding company (as defined in 12 U.S.C. 1842) or a savings and loan holding company (as defined in 12 U.S.C. 1467a), the capital adequacy guidelines applicable to bank holding companies under the Board's Regulation Y (12 CFR part 225);

(c) In the case of a covered swap entity that is foreign banking organization (as defined in 12 CFR 211.21(o)) or any state branch or state agency of a foreign bank (as defined in 12 U.S.C. 3101(b)(11) and (12)), the capital rules that are made applicable to such covered swap entity pursuant to § 225.2(r)(3) of the Board's Regulation Y (12 CFR 225.2(r)(3)); and

(d) In the case of a covered swap entity that is an Edge or agreement corporation (as defined in 12 CFR 211.1(c)(2) and (3)), the capital adequacy guidelines that are made applicable to an Edge corporation engaged in banking pursuant to § 211.12(c)(2) of the Board's Regulation K (12 CFR 211.12(c)(2)).

FEDERAL DEPOSIT INSURANCE CORPORATION

List of Subjects in 12 CFR Part 324

12 CFR Chapter III

Banks, Reporting and recordkeeping requirements, Holding companies, Savings associations.

Authority and Issuance

For the reasons set forth in the Supplementary Information, the Federal Deposit Insurance Corporation proposes to add the text of the common rule as set forth at the end of the Supplementary Information as part 324 to chapter III of Title 12, Code of Federal Regulations, modified as follows:

PART 324—MARGIN AND CAPITAL REQUIREMENTS FOR COVERED SWAP ENTITIES

13. The authority citation for part 324 is added to read as follows:

Authority: 7 U.S.C. 6s(e), 15 U.S.C. 78o–10(e), and 12 U.S.C. 1818 and 12 U.S.C. 1819(a)(Tenth).

14. Part 324 is added as set forth at the end of the Common Preamble.

15. Part 324 is amended by:

a. Removing "[Agency]" wherever it appears and adding in its place "the FDIC";

b. Removing "[The Agency]" wherever it appears and adding in its place "The FDIC"; and

c. Removing "[capital metric]" wherever it appears and adding in its place "tier 1 capital".

16. Section 324.1 is added to read as follows:

§ ____.1 Authority, purpose, and scope.

(a) *Authority.* This part is issued by the Federal Deposit Insurance Corporation (FDIC) under section 4s(e) of the Commodity Exchange Act (7 U.S.C. 6s(e)), section 15F(e) of the Securities Exchange Act of 1934 (15 U.S.C. 78o–10(e)), and section 8 of the Federal Deposit Insurance Act (12 U.S.C. 1818).

(b) *Purpose.* Section 4s of the Commodity Exchange Act (7 U.S.C. 6s) and section 15F of the Securities Exchange Act of 1934 (15 U.S.C. 78*o*–8) require the FDIC to establish capital and margin requirements for any FDIC-insured state-chartered bank that is not a member of the Federal Reserve System or FDIC-insured state-chartered savings association that is registered as a swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant with respect to all non-cleared swaps and non-cleared security-based swaps. This part implements section 4s of the Commodity Exchange Act and section 15F of the Securities Exchange Act of 1934 by defining terms used in the statutes and related terms, establishing capital and margin requirements, and explaining the statutes' requirements.

(c) *Scope.* This part establishes minimum capital and margin requirements for each covered swap entity subject to this part with respect to all non-cleared swaps and non-cleared security-based swaps. This part applies to any non-cleared swap or non-cleared security-based swap entered into by a covered swap entity on or after [INSERT DATE THAT IS 180 DAYS AFTER PUBLICATION OF THE FINAL RULE IN THE FEDERAL REGISTER]. Nothing in this part is intended to prevent a covered swap entity from collecting margin in amounts greater than are required under this part.

17. Paragraph (c) of § 324.2 is added to read as follows:

* * * * *

(c) *Covered swap entity* means any FDIC-insured state-chartered bank that is not a member of the Federal Reserve System or FDIC-insured state-chartered savings association that is a swap entity, or any other entity that the FDIC determines.

* * * * *

18. Section 324.10 is added to read as follows:

§ ____.10 Capital requirement.

A covered swap entity shall comply with the capital adequacy guidelines that are applicable to the covered swap entity and have been adopted by the FDIC under section 38 of the Federal Deposit Insurance Act (12 U.S.C. 1831o).

FARM CREDIT ADMINISTRATION

List of Subjects in 12 CFR Part 624

Agriculture, Banks, Banking, Credit, Rural areas.

Authority and Issuance

For the reasons set forth in the Supplementary Information, the Farm Credit Administration proposes to add the text of the common rule as set forth at the end of the Supplementary Information as part 624 to chapter VI of Title 12, Code of Federal Regulations, modified as follows:

PART 624—MARGIN AND CAPITAL REQUIREMENTS FOR COVERED SWAP ENTITIES

19. The authority citation for part 624 is added to read as follows:

Authority: 7 U.S.C. 6s(e), 15 U.S.C. 78o–10(e), and secs. 4.3, 5.9, 5.17, and 8.32 of the Farm Credit Act (12 U.S.C. 2154, 12 U.S.C. 2243, 12 U.S.C. 2252, and 12 U.S.C. 2279bb–1).

20. Part 624 is added as set forth at the end of the Common Preamble.

21. Part 624 is amended by:

a. Removing "[Agency]" wherever it appears and adding in its place "the FCA";

a. Removing "[The Agency]" wherever it appears and adding in its place "The FCA"; and

c. Removing "[capital metric]" wherever it appears and adding in its place "core surplus or core capital, as applicable".

22. Section 624.1 is added to read as follows:

§ 624.1 Authority, purpose, and scope.

(a) *Authority.* This part is issued by the Farm Credit Administration (FCA) under section 4s(e) of the Commodity Exchange Act (7 U.S.C. 6s(e)), section 15F(e) of the Securities Exchange Act of 1934 (15 U.S.C. 78o–10(e)), and sections 4.3, 5.9, 5.17, and 8.32 of the Farm Credit Act (12 U.S.C. 2154, 12 U.S.C. 2243, 12 U.S.C. 2252, and 12 U.S.C. 2279bb–1).

(b) *Purpose.* Section 4s of the Commodity Exchange Act (7 U.S.C. 6s) and section 15F of the Securities Exchange Act of 1934 (15 U.S.C. 78*o*–8) require the FCA to establish capital and margin requirements for any System institution, including the Federal Agricultural Mortgage Corporation, chartered under the Farm Credit Act of 1971, as amended (12 U.S.C. 2001 *et seq.*) that is registered as a swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant with respect to all non-cleared swaps and non-cleared security-based swaps. This regulation implements section 4s of the Commodity Exchange Act and section 15F of the Securities Exchange Act of 1934 by defining terms used in the statute and related terms, establishing capital and margin requirements, and explaining the statute's requirements.

(c) *Scope.* This part establishes minimum capital and margin requirements for each covered swap entity subject to this part with respect to all non-cleared swaps and non-cleared security-based swaps. This part applies to any non-cleared swap or non-cleared security-based swap entered into by a covered swap entity on or after [INSERT DATE THAT IS 180 DAYS AFTER PUBLICATION OF THE FINAL RULE IN THE FEDERAL REGISTER]. Nothing in this part is intended to prevent a covered swap entity from collecting margin in amounts greater than are required under this part.

23. Paragraph (c) of § 624.2 is added to read as follows:

§ 624.2 Definitions.

* * * * *

(c) *Covered swap entity* means any institution chartered under the Farm Credit Act of 1971, as amended (12 U.S.C. 2001 *et seq.*) that is a swap entity,

or any other entity that the FCA determines.

* * * * *

24. Section 624.10 is added to read as follows:

§ 624.10 Capital requirement.

A covered swap entity shall comply with:

(a) In the case of the Federal Agricultural Mortgage Corporation, the capital adequacy regulations set forth in 12 CFR part 652; and

(b) In the case of any Farm Credit System institution other than the Federal Agricultural Mortgage Corporation, the capital regulations set forth in 12 CFR part 615.

25. Section 624.11 is added to read as follows:

§ 624.11 Special requirements for transactions between swap entities and System institutions.

(a) *Margin requirements.* To the extent that a System institution, including the Federal Agricultural Mortgage Corporation, that is not a covered swap entity enters into a non-cleared swap or a non-cleared security-based swap with a swap entity, the System institution shall:

(1) Collect initial margin from the swap entity in an amount and at such times as would be in accordance with the requirements of § 624.3, provided that for purposes of this § 624.10 any reference to "initial margin model" in the definition of "initial margin collection amount" shall mean:

(i) The System institution's initial margin model, if any, or

(ii)(A) If the System institution does not have an initial margin model, an initial margin model used by a third party to calculate initial margin on behalf of the System institution in accordance with § 624.3, provided that the third party is itself independent of the swap entity that is the counterparty in the transaction at issue.

(B) The amounts of initial margin collected under this paragraph (a) may be adjusted for minimum transfer amounts as allowed under § 624.3(c).

(2) Collect variation margin daily from the swap entity in an amount that would be in accordance with the requirements in §§ 624.4(a) and 624.4(e). The amounts of variation margin collected under this paragraph may be adjusted as allowed for minimum transfer amounts under § 624.4(c) and for qualifying master netting agreements under § 624.4(d).

(b) *Documentation.* To the extent that a System institution enters into a non-cleared swap or a non-cleared security-based swap with a swap entity, the System institution shall execute trading documentation with such swap entity in accordance with the requirements of § 624.5.

(c) *Collateral.* Any initial or variation margin that a System institution is required to collect from a swap entity under paragraph (a) of this section shall meet the eligible collateral requirements of § 624.6.

(d) *Segregation.* A System institution shall require that any funds or other property that it posts to a swap entity as initial or variation margin be held by a third-party custodian that is independent of the swap entity and the System institution, is located in a jurisdiction that applies the same insolvency regime to the third-party custodian as would apply to the System institution, and is subject to the rehypothecation, reinvestment, and other transfer restrictions of § 624.7

(e) *Initial margin models.* To the extent the initial margin collection amount that the System institution is required to collect from a swap entity under paragraph (a)(1) of this section is calculated by the System institution using an initial margin model, such model must meet all the requirements of § 624.8, provided that the appropriate prudential regulator responsible for making or rescinding any approvals to the extent required or allowed under § 624.8 shall be:

(1) In the case where the initial margin model is that of a third party that is subject to regulation by a prudential regulator, the prudential regulator having such jurisdiction; or

(2) In the case where the initial margin model is that of either the System institution or a third party that is not subject to regulation by a prudential regulator, the FCA.

FEDERAL HOUSING FINANCE AGENCY

List of Subjects in 12 CFR Part 1221

Government-sponsored enterprises, Mortgages, Securities.

Authority and Issuance

For the reasons stated in the **SUPPLEMENTARY INFORMATION,** and under the authority of 7 U.S.C. 6s(e), 15 U.S.C. 78o–10(e), and 12 U.S.C. 4526, the Federal Housing Finance Agency proposes to add the text of the common rule as set forth at the end of the **SUPPLEMENTARY INFORMATION** as part 1221 of subchapter B of chapter XII of title 12 of the Code of Federal Regulations, modified as follows:

CHAPTER XII—FEDERAL HOUSING FINANCE AGENCY

SUBCHAPTER B—ENTITY REGULATIONS

PART 1221—MARGIN AND CAPITAL REQUIREMENTS FOR COVERED SWAP ENTITIES

26. The authority citation for part 1221 is added to read as follows:

Authority: 7 U.S.C. 6s(e), 15 U.S.C. 78o–10(e), 12 U.S.C. 4513 and 12 U.S.C. 4526(a).

27. Part 1221 is added as set forth at the end of the Common Preamble.

28. Part 1221 is amended by:

a. Removing "[Agency]" wherever it appears and adding in its place "FHFA";

b. Removing "[The Agency]" wherever it appears and adding in its place "FHFA"; and

c. Removing "[capital metric]" wherever it appears and adding in its place "total capital".

29. Section 1221.1 is added to read as follows:

§ 1221.1 Authority, purpose, and scope.

(a) *Authority.* This part is issued by the Federal Housing Finance Authority (FHFA) under section 4s(e) of the Commodity Exchange Act (7 U.S.C. 6s(e)), section 15F(e) of the Securities Exchange Act of 1934 (15 U.S.C. 78o–10(e)), 12 U.S.C. 4513 and 12 U.S.C. 4526(a).

(b) *Purpose.* Section 4s of the Commodity Exchange Act (7 U.S.C. 6s) and section 15F of the Securities Exchange Act of 1934 (15 U.S.C. 78o–8) require FHFA to establish capital and margin requirements for any regulated entity that is registered as a swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant with respect to all non-cleared swaps and non-cleared security-based swaps. This regulation implements section 4s of the Commodity Exchange Act and section 15F of the Securities Exchange Act of 1934 by defining terms used in the statute and related terms, establishing capital and margin requirements, and explaining the statute's requirements.

(c) *Scope.* This part establishes minimum capital and margin requirements for each covered swap entity subject to this part with respect to all non-cleared swaps and non-cleared security-based swaps. This part applies to any non-cleared swap or non-cleared security-based swap entered into by a covered swap entity on or after [INSERT DATE THAT IS 180 DAYS AFTER PUBLICATION OF THE FINAL RULE IN THE FEDERAL REGISTER]. Nothing in this part is intended to prevent a covered swap entity from

collecting margin in amounts greater than is required under this part.

30. Section 1221.2 is amended as follows:

a. Add paragraph (c);

b. Redesignate paragraphs (z), (aa) and (bb) as paragraphs (bb), (cc), and (dd), respectively;

c. Redesignate paragraphs (u) through (y) as (v) through (z); and

d. Add new paragraphs (u) and (aa).

§ 1221.2 Definitions.

* * * * *

(c) *Covered swap entity* means any regulated entity that is a swap entity, or any other entity that FHFA determines.

* * * * *

(u) *Regulated entity* means any regulated entity as defined in section 1303(20) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 U.S.C. 4502(20)).

* * * * *

(aa) *Total capital* means:

(1) In the case of any Federal Home Loan Bank, "total capital" as such term is defined in 12 CFR 1229.1; and

(2) In the case of the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, or any of their respective affiliates, "total capital" as such term is defined in 12 CFR 1750.11.

* * * * *

31. Section 1221.10 is added to read as follows:

§ 1221.10 Capital.

A covered swap entity shall comply with the risk-based capital level or such other amount applicable to the covered swap entity as required by the Director of FHFA pursuant to 12 U.S.C. 4611.

32. Section 1221.11 is added to read as follows:

§ 1221.11 Special requirements for transactions between swap entities and regulated entities.

(a) *Margin requirements.* To the extent that a regulated entity that is not a covered swap entity enters into a non-cleared swap or a non-cleared security-based swap with a swap entity, the regulated entity shall:

(1) Collect initial margin from the swap entity in an amount and at such times as would be in accordance with the requirements of § 1221.3, provided that for purposes of this section any reference to "initial margin model" in the definition of "initial margin collection amount" shall mean:

(i) The regulated entity's initial margin model, if any, or

(ii) (A) If the regulated entity does not have an initial margin model, an initial margin model used by a third party to calculate initial margin on behalf of the regulated entity in accordance with § 1121.3, provided that the third party is itself independent of the swap entity that is the counterparty in the transaction at issue.

(B) The amounts of initial margin collected under this paragraph may be adjusted for minimum transfer amounts as allowed under § 1221.3(c).

(2) Collect variation margin daily from the swap entity in an amount that would be in accordance with the requirements in § 1221.4(a) and § 1221.4(e). The amounts of variation margin collected under this paragraph may be adjusted as allowed for minimum transfer amounts under § 1221.4(c) and for qualifying master netting agreements under § 1221.4(d).

(b) *Documentation.* To the extent that a regulated entity enters into a non-cleared swap or a non-cleared security-based swap with a swap entity, the regulated entity shall execute trading documentation with such swap entity in accordance with the requirements of § 1221.5.

(c) *Collateral.* Any initial or variation margin that a regulated entity is required to collect from a swap entity under paragraph (a) of this section shall meet the eligible collateral requirements of § 1221.6.

(d) *Segregation.* A regulated entity shall require that any funds or other property that it posts to a swap entity as initial or variation margin be held by a third-party custodian that is independent of the swap entity and the regulated entity, is located in a jurisdiction that applies the same insolvency regime to the third-party custodian as would apply to the regulated entity, and is subject to the rehypothecation, reinvestment, and other transfer restrictions of § 1221.7.

(e) *Initial margin models.* To the extent the initial margin collection amount that the regulated entity is required to collect from a swap entity under paragraph (a)(1) of this section is calculated by the regulated entity using an initial margin model, such model must meet all the requirements of § 1221.8, provided that the appropriate prudential regulator responsible for making or rescinding any approvals or taking other action to the extent required or allowed under § 1221.8 shall be:

(1) In the case where the initial margin model is that of a third party that is subject to regulation by a prudential regulator, the prudential regulator having such jurisdiction; or

(2) In the case where the initial margin model is that of either the regulated entity or a third party that is not subject to regulation by a prudential regulator, FHFA.

Dated: April 11, 2011.

John Walsh,

Acting Comptroller of the Currency.

By order of the Board of Governors of the Federal Reserve System, April 12, 2011.

Jennifer J. Johnson,

Secretary of the Board.

Dated at Washington, DC, this 12th of April 2011.

By order of the Board of Directors.

Federal Deposit Insurance Corporation.

Robert E. Feldman,

Executive Secretary.

Dated: April 11, 2011.

Dale L. Aultman,

Secretary, Farm Credit Administration Board.

Dated: April 11, 2011.

Edward J. DeMarco,

Acting Director, Federal Housing Finance Agency.

[FR Doc. 2011–10432 Filed 5–10–11; 8:45 am]

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