



Commodity Futures Trading Commission

Office of Public Affairs

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Fact Sheet and Q&A – Notice of Proposed Rulemaking to Amend the Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants: Seeded Funds and Money Market Funds

The Commodity Futures Trading Commission (“Commission” or “CFTC”) is proposing to amend Regulations 23.151 and 23.156 to: (i) provide a limited exemption to swap dealers and major swap participants from the requirement to exchange initial margin on uncleared swaps with certain start-up investment funds; (ii) eliminate a provision that disqualifies certain money market and similar funds engaging in repurchase or similar transactions from being eligible as initial margin collateral for uncleared swaps; and (iii) add a footnote to the haircut schedule for eligible collateral to specify the discount rate applicable to money market and similar funds.

Background

Regulations 23.150 through 23.161 (“CFTC Margin Rule”) impose margin requirements on uncleared swap contracts entered into by swap dealers and major swap participants for which there is no prudential regulator (“covered swap entities”).

Among other requirements, the CFTC Margin Rule mandates that covered swap entities exchange initial margin with financial end users, including investment funds, with material swaps exposure. An investment fund has material swaps exposure if the fund and its margin affiliates have a month-end average aggregate notional amount of uncleared swaps and certain other financial contracts with all counterparties in excess of \$8 billion. A covered swap entity is required to post and collect initial margin with an investment fund with material swaps exposure if the initial margin, calculated based on the credit exposure from uncleared swaps between the covered swap entity and its margin affiliates on the one hand, and the fund and its margin affiliates on the other, exceeds a \$50 million initial margin threshold.

Under the CFTC Margin Rule, initial margin obligations may be satisfied only with specified forms of collateral. The current list of eligible collateral includes interests in certain money market and similar funds that invest only in cash and securities issued, or unconditionally guaranteed, by the U.S. Department of the Treasury, the European Central Bank, or certain other sovereign entities (“government MMFs”), provided that such funds do not engage in repurchase or similar transactions with fund assets, among other restrictions.

Based on its experience administering the CFTC Margin Rule since its promulgation in 2016 and in consideration of relevant market participants’ feedback, the Commission proposed for comment the following amendments to its margin requirements for uncleared swaps:

1. Revise the definition of “margin affiliate” in Regulation 23.151 to provide that an investment fund that receives start-up capital from an affiliated sponsor meeting certain requirements (“seeded fund”) is deemed not to have margin affiliates for the purpose of calculating the seeded fund’s material swaps exposure and \$50 million initial margin threshold amount. The proposal would exclude a seeded fund from initial margin requirements for a period not to exceed three years from the fund’s trading inception date to provide an opportunity for the seeded fund to develop a performance record and to attract outside investors (“eligible seeded fund exception”);

2. Define the term “eligible seeded fund” to set forth the conditions that a start-up investment fund must meet to qualify for the eligible seeded fund exception;
3. Eliminate the restriction in Regulation 23.156(a)(1)(ix) that prohibits securities of government MMFs from qualifying as eligible margin collateral if the managers of the government MMFs are authorized to transfer fund assets through repurchase or similar arrangements (“asset transfer restriction”); and
4. Amend the haircut schedule for eligible collateral set forth in Regulation 23.156(a)(3)(i)(B) to specify the percentage discount applicable to the securities of government MMFs.

Objective

The Commission is seeking to amend its margin requirement for uncleared swaps to address challenges identified in the implementation of the requirements and to further harmonize its requirements with those of other international markets that have adopted the Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions’ Framework for margin requirements for non-centrally cleared derivatives.¹

The Commission believes that the proposal supports the CFTC Margin Rule’s objective of imposing margin requirements that are commensurate with the risk of uncleared swaps entered into by covered swap entities, consistent with the Commodity Exchange Act’s mandate, set forth in Section 4s(e) of the Act, that the Commission adopt rules that are “appropriate for the risk associated with” the uncleared swaps held by swap dealers and major swap participants.

Proposed Rulemaking Q & A

1. Who would be affected by the proposed changes?

- Covered swap entities that enter into swap transactions with counterparties that are eligible seeded funds.
- Covered swap entities and counterparties that use, or intend to use, shares of government MMFs as initial margin collateral for uncleared swap transactions.

2. What policy considerations motivated the proposed changes?

Under the current CFTC Margin Rule, seeded funds calculate the thresholds that trigger compliance with the initial margin requirements by including their sponsor’s and other consolidated affiliates’ exposures. As a result, even if seeded funds have limited swaps activity and related exposures, they may need to exchange initial margin with covered swap entities if the seeded funds cross the compliance thresholds on a consolidated group basis with their sponsor and other affiliates. In proposing the “eligible seeded fund exception,” the Commission intends to establish a consistent treatment of seeded funds that are consolidated within a group of entities that collectively exceed the initial margin compliance thresholds and similar funds that are not part of such a group or subject to such a requirement.

In addition, the Commission believes that seeded funds do not pose significant risks to their swap counterparties or systemic risk to the financial system given that their typical capitalization does not exceed \$50-100 million and the gross notional amount of their swaps is small. The Commission also believes that the proposal would promote capital formation.

In proposing to eliminate the asset transfer restriction, the Commission is addressing the potential risk of concentration of margin collateral in the securities of a few government MMFs and contribute to more efficient collateral management practices. In connection with this proposal, the Commission considered the regulatory framework applicable to money market funds and the historic performance of money market funds in times of financial stress. In that regard, the U.S. Securities and Exchange Commission has noted in its recent reforms of money market funds that investors typically view U.S. government money market funds – a category that includes the type of funds that may qualify as eligible collateral under Regulation 23.156 – as relatively safe investments during

¹ See BCBS/IOSCO, *Margin requirements for non-centrally cleared derivatives* (April 2020), <https://www.bis.org/bcb/publ/d499.pdf>.

times of market turmoil.² As a result, government money market funds, in contrast to prime money market funds that invest in short-term corporate securities, have generally experienced liquidity inflows during periods of stress.

3. Would the proposal expand the categories of money market funds that are eligible as initial margin collateral?

No. Currently, the only money market fund shares that may be used as initial margin collateral under Regulation 23.156 are shares issued by government MMFs. As noted above, to qualify as margin collateral, government MMFs may invest **only** in: (i) securities issued, or unconditionally guaranteed, by the U.S. Department of the Treasury, and cash denominated in U.S. dollars; or (ii) securities denominated in a common currency and issued by, or fully guaranteed by, the European Central Bank or a sovereign entity that is assigned no higher than a 20 percent risk weight, and cash denominated in the same currency. The Commission is **not** proposing to change these requirements. The Commission is **not** proposing, and is not contemplating in the proposal, any change in the CFTC Margin Rule that would permit shares of money market funds that invest in short-term corporate securities (*i.e.*, prime money market funds) to be used as initial margin collateral for uncleared swaps transactions.

4. Why is the Commission proposing to remove the restriction on government MMFs engaging in repurchase transactions with fund assets?

The Commission is proposing to remove the restriction on government MMFs engaging in repurchase transactions or similar transactions with fund assets to provide for more efficient collateral management practices by swap market participants and to address potential concentration risk that exists under the current rule. Specifically, only a small number of government MMFs do not engage in repurchase or similar transaction with fund assets, and removing the restriction would greatly expand the number of government MMFs available for use as initial margin collateral. In addition, money market funds generally engage in repurchase or similar transactions on a collateralized basis mitigating potential credit risk to a government MMF in the event of a counterparty default.

5. What safeguards exist to limit the uncollateralized credit exposure that would potentially result from applying the eligible seeded fund exception?

The proposed exception would apply only to initial margin. Covered swap entities and seeded funds would continue to be required to exchange variation margin on a daily basis, subject to a minimum transfer amount of \$500,000 currently set forth in the CFTC Margin Rule. The exchange of variation margin reduces overall counterparty exposure by ensuring that gains and losses on swap positions are settled between counterparties on a daily basis.

The exception is also narrowly tailored in that a covered swap entity may forgo collecting and posting initial margin with an eligible seeded fund for a maximum of three years from the date the fund starts trading. In addition, the proposed exception would only apply for purposes of calculating the material swaps exposure threshold and the initial margin threshold amount applicable to the fund; the sponsor entity and other affiliates that do not independently qualify for the exception would have to count the eligible seeded fund's swap exposures when calculating their thresholds.

Separately, covered swap entities would continue to be subject to capital requirements based on their uncollateralized swap exposures, including swap exposures to eligible seeded funds.

6. Why is the proposed eligible seeded fund exception limited to three years?

² *Money Market Fund Reforms; Form PF Reporting Requirements for Large Liquidity Fund Advisers, Technical Amendments to Form N-CSR and Form N-1A*, 88 FR 51404 (Aug. 3, 2023) at 51417. The term "government money market fund" is defined in Rule 2a-7 under the Investment Company Act of 1940 ("SEC Rule 2a-7") as a money market fund that invests 99.5 percent or more of its total assets in cash, government securities, and/or repurchase agreements that are collateralized fully. "Government security" is in turn defined in 15 U.S.C. 80a-2(a)(16) as "any security issued or guaranteed as to principal or interest by the United States, or by a person controlled or supervised by and acting as instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States; or any certificate of deposit of any of the foregoing." Therefore, government money market funds, as defined in SEC Rule 2a-7, may encompass the category of funds described in Regulation 23.156(a)(1)(ix)(A).

The three-year term is intended to provide an appropriate period of time for a seeded fund to establish a sufficient performance record to draw in third-party investors while also ensuring that there is a defined date for the termination of the seeded fund's initial margin exception.

7. To what extent do the proposed amendments follow the recommendations of the Global Markets Advisory Committee's Subcommittee on Margin Requirements?

The Commission has five active advisory committees that provide input and make recommendations to the Commission on a variety of regulatory and market issues that affect the integrity and competitiveness of the U.S. derivatives markets. Although the proposal originated in connection with a series of recommendations provided to the Commission in a report by a subcommittee of one of the five active advisory committees, the Global Markets Advisory Committee ("GMAC"),³ the Commission also conducted its own analysis in determining the proposed amendments for which the Commission is seeking public comment. With respect to the proposed eligible seeded fund exception, the proposal contains eight conditions designed to ensure that the proposed exception is narrowly tailored to the seeded funds identified by the GMAC Report. In addition, the Commission set forth proposed conditions that are stricter than the GMAC Report's recommended parameters. For instance, one of the proposed conditions is that the seeded fund must not be collateralized, guaranteed, or otherwise supported, directly or indirectly, with respect to any of its obligations, by the sponsor or an affiliate of the sponsor, another fund, or the asset manager. This condition is stricter than the proposed condition in the GMAC Report, which suggested that the fund must not be collateralized, guaranteed, or otherwise supported in the event of bankruptcy.

8. Why is the Commission proposing the amendments at this time?

The GMAC Report was issued in May 2020. Subsequent to the issuance of the report, the Commission completed two rulemakings to address three of the ten recommendations in the GMAC Report that were time-sensitive due to pending compliance dates of the original rule and other factors.⁴ The recommendations regarding seeded funds and government MMFs, however, required further Commission staff review and analysis that was only completed recently.

³ See *Recommendations to Improve Scoping and Implementation of Initial Margin Requirements for Non-Cleared Swaps, Report to the CFTC's Global Markets Advisory Committee by the Subcommittee on Margin Requirements for Non-Cleared Swaps (May 2020)* ("GMAC Report"), https://www.cftc.gov/media/3886/GMAC_051920MarginSubcommitteeReport/download.

⁴ See *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 86 FR 229 (Jan. 5, 2021) and *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 86 FR 6850 (Jan. 25, 2021).