Clearing Up The Uncleared Margin Rules

A Comprehensive Guide for Hedge Fund and Asset Managers

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KEY TAKEAWAYS

- New rules will affect the way that many funds deal with initial margin for uncleared OTC transactions.
- Funds which are in scope and not compliant with the rules will be prevented from transacting in un-cleared OTC derivatives.
- The rules involve two large changes:
  1) Swap dealers and funds will both be required to exchange IM with one another; and
  2) IM must now rest with third party custodians.
- Impacted funds will need new legal documentation and operational changes to comply with the rules.
- Managers must act quickly to assess whether they are impacted and make necessary preparations.

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SUMMARY

This article provides an overview of the regulations for initial margin on uncleared OTC derivatives ("UMR" or the "Rules") and explains to hedge fund managers and asset managers ("managers") how they need to prepare for these changes as Phase 6 of the rules take effect in September 2022.

After being narrowed in their scope and delayed in their implementation, new rules surrounding initial margin ("IM") in uncleared OTC transactions ("U-OTC") have come into play in phases and soon will affect an even larger number of managers' funds ("funds") and other buy-side institutions. While the United States Rules will not typically regulate funds directly, funds will be indirectly regulated by the Rules via their swap dealers ("SDs") who will require their counterparties to comply with the Rules. In the United States, the Rules are issued by the Prudential Regulators and CFTC, but they ultimately stem from the G20's ongoing efforts to enact post-2008 crisis regulatory reforms in the hopes of creating a more resilient financial system.

The reforms will impact funds in two main ways. First, SDs and funds will both be required to post IM to one another. Second, IM can no longer be transferred directly between counterparties and re-hypothecated; it must now be held in segregated accounts with an unaffiliated third-party custodian where it cannot be re-hypothecated, insulating it from the risk of counterparty default. Further, requirements for how IM is to be calculated and the types of collateral that can be used are prescribed by the Rules.

While the Rules will only apply to new transactions that are entered into after a certain date, this fact may inconveniently create multiple workflows for managers monitoring their new and legacy transactions.

Beyond operational changes, managers will need to negotiate, enter new legal agreements, and modify existing agreements to deal with the Rules. In some cases, managers may even wish to alter their trading strategies and operations to mitigate or steer clear of the Rules by using portfolio compression or by reducing their use of U-OTC products.

To avoid getting caught in a regulatory bottleneck, managers must act immediately to: 1) determine whether they are in scope of the Rules; 2) determine their IM requirements; and 3) choose their service providers in the areas of custody, monitoring/technology, and legal services. Beyond this, managers must also consider how to best navigate the strategic and operational challenges posed by the coming Rules.

INTRODUCTION

There has been lengthy debate and discussion surrounding UMR for several years. In that time, the regulations, which initially seemed like they would overhaul the way that many funds deal with collateral for U-OTC transactions have been narrowed in scope, and their final phases of implementation were delayed a year. Phase 5, however, took effect in September 2021 and Phase 6 of the regulations are scheduled for September 2022.

Phase 6 will make more funds subject to the Rules – and it is now critical for every manager to assess whether their fund(s) will be impacted. The Rules are being phased in progressively, beginning with the largest market participants and applying to the smaller ones later. Between recently implemented Phase 5 and upcoming Phase 6, over 1,100 firms are expected to become subject to UMR in the final phases of implementation.[2]

"It is now critical for every manager to assess whether their fund(s) will be impacted."

Now, there is no need for alarm. Many funds will never come into scope as they will fall below the thresholds required to trigger the application of the Rules. Moreover, if you are a manager who is new to or vaguely familiar with this topic, you are reading at the right time. We finally have a good idea of what this will look like and how it will affect managers. While there is time to prepare, managers shouldn't underestimate the degree of preparation involved.

This article goes over the who, what, where, when, why, and how of UMR for IM. The Rules will require many funds to overhaul their legal documents and we will guide managers through the path that lies ahead.

This article will focus primarily on UMR in the United States. The Rules in other jurisdictions (such as EU, Japan, and Canada) are similar but there are differences which this article will highlight without exploring in an exhaustive manner.

2 See Jack Callahan (Executive Director of OTC products and services CME Group), "50 billion: The new magic number for initial margin rules" (2 Aug 2019), online: **https://openmarkets.cmegroup.com/15384/50-billion-the-new-magic-number-for-initial-margin-rules**.

WHAT ARE THE UNCLEARED MARGIN RULES?

UMR is a set of rules that apply to margin (i.e., collateral) on U-OTC derivatives. U-OTC are almost exclusively traded under the legal framework provided by the International Swaps and Derivatives Association ("**ISDA**"), namely the ISDA Master Agreement ("**ISDA MA**"), and collateral for them is exchanged under an ISDA Credit Support Annex ("**CSA**").[3] The Rules apply to variation margin ("**VM**") and IM on U-OTC. The Rules for VM were implemented in 2017, but the IM Rules continue to be phased in (starting from 2016 for the largest institutions and continuing into 2022 when smaller institutions and buy-side firms come into scope).

At a high level, UMR for IM requires that in-scope counterparties exchange IM in line with regulatory requirements (amount and type of collateral), and that such collateral be held in segregated accounts.

BACKGROUND TO THE RULES – WHERE DID THEY COME FROM?

The rules were developed in response to the 2008 financial crisis and the collapse of Lehman Brothers. At the 2009 G20 summit in Pittsburgh, global leaders committed to implementing a more robust regulatory framework around U-OTC.[4] This led to reforms such as the Dodd-Frank Act in the United States and EMIR in Europe.

The regulators in each jurisdiction have since adopted legislation which have impacted the industry at-large.

UMR is a subset of these global reforms and was first laid out by the Basel Committee on Banking Supervision ("BCBS") and the International Organization of Securities Commissions ("IOSCO") in 2013.[5] These international bodies are mandated by the G20 and, after they issue rules, member countries of the G20 then individually implement similar rules into their national legal systems (the United States did this with Dodd-Frank) and then via regulation. Specifically, UMR is being implemented in the United States via the Prudential Regulators[6] and the CFTC. Thus, the Rules apply to the institutions regulated by the Prudential Regulators: the banks. In the United States, Funds are not directly regulated with respect to UMR but must comply with the Rules since their SDs[7] need to comply when transacting with them.

3 There are multiple types of CSAs published by ISDA. Some cover VM and others address IM. The choice of CSA will depend on the jurisdiction as well as legal/operational/custodial arrangements.

4 For a brief review of these reforms, see Wharton Public Policy Initiative, "2009 PITTSBURGH G20 SUMMIT: A LOOK BACK AT ITS IMPACT ON DERIVATIVES MARKETS AND CHALLENGES THAT REMAIN" (25 Oct 2018), online: https://publicpolicy.wharton.upenn.edu/live/news/2666-2009-pittsburgh-g20-summit-a-look-back-at-its.

5 This was done following multiple proposals by the Working Group on Margining Requirements (WGMR). See Basel Committee on Banking Supervision & Board of the International Organization of Securities Commissions, "Margin requirements for non-centrally cleared derivatives" (Jul 2019), online: https://www.bis.org/bcbs/publ/d475.pdf. For the original document on the framework, see "BCBS-IOSCO Final Framework on Margin Requirements for Non-Centrally Cleared Derivatives" (Sep 2013), online: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD423.pdf.

6 The US Prudential Regulators include the Treasury Department's Office of the Comptroller of the Currency ("OCC"), the Board of Governors of the Federal Reserve System ("Fed"), the Federal Deposit Insurance Corporation ("FDIC"), the Farm Credit Administration ("FCA"), and the Federal Housing Finance Agency ("FHFA").

7 To be clear, the swap dealers are also known as the "counterparties." Both parties to an U-OTC transaction are counterparties to one another. To assist in making distinctions between counterparties which are HFs and those which are SDs, we will use the term SD instead of counterparty throughout this article.

BASICS – WHAT IS MARGIN FOR UNCLEARED OTC DERIVATIVES?

Margin – otherwise known as collateral for U-OTC – is essentially a transfer of cash or securities to one party that is meant to protect it against losses resulting from the default of the other party to the trade (i.e., such party's inability to pay or satisfy its obligations). There are three types of margin:

1. Variation Margin ("VM")

This margin is transferred between parties based on the movement of the mark-to-market value of the underlying U-OTC transaction. In other words, during the life of an U-OTC transaction, the value of the underlying asset (or thing) from which the U-OTC transaction derives its value will fluctuate, thereby affecting the value of the transaction were it to mature on a given day. VM thus captures changes in the unrealized profit or loss on the trade. Typically, VM is transferred daily using the mark-to-market value of the asset as determined from the previous day.[8]

2. Initial Margin ("IM")

IM is intended to serve as a buffer throughout the life of a transaction, which protects one party against the default of the other party. Unlike VM, IM is not based on the mark-to-market value. Rather, IM is based on the theoretical losses which a party might suffer if the other party to the transaction defaults. These losses represent the expected movements in the market that might occur before the non-defaulting party is able to close out its swap exposure.

As mentioned previously, the Rules for VM were implemented in 2017. It is the Rules for IM which are now being phased in progressively.

3. Independent Amount (vs. IM)

Prior to the advent of UMR, SDs recognized the risk that a loss could occur in the event of a counterparty/fund default, due to market movements between the time of the last VM movement and the closing out of the swap exposure. To account for this risk, SDs would impose an additional margin requirement on certain counterparties whom they viewed as having a high-risk profile, typically funds. This additional margin requirement may be calculated in many ways, depending on the particular arrangement between the SD and the fund, as well as the SD's credit appetite. Because a SD has a better credit profile than a fund, the SD would impose this additional margin requirement on the fund. The SD would typically not post this additional margin to their fund counterparty in return.

This additional margin requirement was referred to as independent amount ("**IA**") or initial margin. The terms IA and IM were synonymous and often used interchangeably.

As mentioned, following the 2008 financial crisis and the fall of Lehman Brothers, market participants and regulators were compelled to accept the notion that although a SD may have a better credit profile than a Fund, they are not infallible. Thus, the fully bilateral rules for regulatory IM were born. Since the term "initial margin" was used in the regulatory rules, the industry has now generally applied the term "independent amount" to refer specifically to the additional margin required by SDs to funds that is not prescribed by regulation.

To recap, IM is required by the Rules. IA is the additional margin which was and will continue to be required by SDs of their fund clients.

Both IA and IM (as well as VM) will co-exist going forward, and their interplay will be determined by the margin approach (covered later in this article) selected by the counterparties to an U-OTC transaction.

WHAT DO THE RULES PROVIDE?

1. Both Parties Are Now Required To Exchange IM

As of 2017, all parties are required to exchange VM, but this was common practice before the Rules relating to VM were implemented. Under UMR, both parties will be required to post IM to one another; this is very new, and it is not a practice that SDs and Funds are accustomed to doing together.

8 Using this lag period of one day is often referred to as a "T+1" basis.

2. IM Must Be Held In Segregated Accounts

When funds are posting IA to their SDs, the usual market practice is for Funds to transfer IA directly to the SD.[9] The SD essentially takes the assets posted (typically cash or securities) onto its balance sheet and can often then rehypothecate these assets as it sees fit. This has the benefit of creating more liquidity in the market. On the downside, however, in the event of the insolvency of the SD, a fund would become a general unsecured creditor and likely recover little to nothing of the IA that it had posted to the SD.

Segregating IM serves the purpose of removing this credit risk. Since IM will now be held at an unaffiliated third-party custodian ("**custodian**"), it will therefore not be impacted by the bankruptcy of the SD. In other words, the collateral will sit at a custodian and the SD cannot rehypothecate it, but the SD retains a security interest over the collateral which allows the SD to take ownership of that collateral if its fund counterparty defaults under the governing document of the transactions (i.e., the ISDA MA). This therefore gives the SD the security that margin is available, but it can only access it after its fund counterparty defaults. If the SD becomes insolvent, transactions would be closed out and, assuming that the fund has satisfied all of its obligations to the SD, it would be permitted to take the IM back without being dragged into a long insolvency proceeding.

"Market participants and regulators were compelled to accept the notion that although a SD may have a better credit profile than a fund, they are not infallible."

Now, recall that under the Rules, both parties must post IM to one another. This means that each party posting IM will appoint its own custodian, and there will thus be two sets of operational flows for the posting of IM. Let's not forget about VM, which will continue to be exchanged between the parties directly, and therefore will not be subject to segregation. This will be another operational flow. These new requirements necessitate several changes for a fund's legal documentation as well as operations – a topic that we will cover later in this article.

3. IM Must Be Determined In Accordance With The Rules

Regulators have prescribed that IM must be determined in accordance with one of the following two methods:

(i) **Grid.** The first is known as the Standard Schedule or Grid. This method provides that certain percentages of IM must be applied to the notional amount of transactions. The percentages vary based on the volatility of the underlying asset referenced by the transaction.[10] The requirement can be reduced by a percentage of the net-to-gross ratio for the set of trades.

Figure 1. Standardized initial margin schedule ("The Grid")

Asset Class	Gross IM (% of Notional)
Credit: 0-2 Years	2
Credit: 2-5 Years	5
Credit: 5+ Years	10
Commodity	15
Equity	15
Foreign Exchange/Currency	6
Cross Ccy Swaps: 0-2 years	1
Cross Ccy Swaps: 2-5 years	2
Cross Ccy Swaps: 5+ years	4
Interest Rate: 5+ years	1
Interest Rate: 0-2 years	2
Interest Rate: 5+ years	4
Other	15

9 We use the term "usual market practice", since segregated collateral options are currently available, but the use is not as widespread as is direct posting between the parties.

10 For the table of percentages, see "Margin requirements for non-centrally cleared derivatives" (July 2019) at page 25, online: https://www.bis.org/bcbs/publ/d475.pdf

(ii) **Risk-Based Methodology.** The second alternative is that regulators can approve a risk-based methodology. To date, the most popular model that has been approved by the regulators is a model put forward by ISDA: the Standard Initial Margin Model **("SIMM")**.[11] It is possible that other models will emerge. The advantage of SIMM is that it will generally result in lower overall IM requirements for a diversified portfolio as opposed to the grid method, since SIMM is a risk-based method that allows for better recognition of offsetting risks within product classes.[12] One might consider Grid for more for directional portfolios where it could be beneficial.

Both models pose challenges to managers as they will need to select which method they will apply, and either (i) work with a vendor, or (ii) develop internally to be able to calculate IM requirements. The regulators were clear that managers may not "cherry pick" which method to use for each trade based only on achieving a lower margin requirement. The method chosen must be consistent and based on other fundamental considerations. Firms should have a clear rationale for their choice as well as any change in methodology they may make. Further, if a manager opts to use SIMM, they will be required to obtain a license agreement with ISDA or work with a licensed vendor of SIMM.

4. The Rules Only Apply To New Transactions

Importantly, once a party becomes subject to the Rules, the UMR requirements only apply to the exchange of IM on U-OTC transactions entered into after the effective date. For instance, if a Fund becomes subject to the Rules as of September 1, 2022, only the transactions entered into after that date will be subject to the IM Rules.[13] One important consideration, however, is that legacy trades, executed prior to the effective date, may still be brought into scope of the Rules if certain trade lifecycle events take place. These events include things like increasing the notional amount of a trade or novating a trade. These lifecycle events were discussed and agreed amongst a working group of industry practitioners prior to the first phase of IM implementation. The full list of such lifecycle events is available from ISDA.[14]

5. Types Of Eligible Collateral

The Rules also prescribe what forms of collateral (e.g., cash, securities) are permissible to be posted as IM. They also define minimum haircuts which should be applied to the value of such posted collateral.[15]

Importantly, there are requirements around the use of cash as IM. For instance, the party posting cash collateral to a custodian must direct the custodian to invest such cash into eligible non-cash collateral. This is necessary due to potential legal issues for a secured party to take a security interest over cash (as opposed to non-cash collateral) held in a segregated collateral account. The restriction on cash also helps to reduce the risk that a loss may occur following a custodian bankruptcy, since non-cash assets held in a segregated account are not taken onto the custodian's balance sheet, as cash is.

6. Jurisdictional Differences – Which Rules Apply?

As alluded to earlier, UMR stems from the G20 and international agreements to regulate margin. However, each country adopts its own legislation into its local law. For the most part, the Rules are similar, but there are some differences, such as determination months, whom the Rules apply to, and threshold amounts which managers should be mindful of when being subjected to the Rules of another jurisdiction.

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11 For the SIMM formula, see International Swaps and Derivatives Association, "ISDA SIMM Methodology, version 2.2" (1 Dec 2019), online: **https://www.isda.org/a/osMTE/ISDA-SIMM-v2.2-PUBLIC.pdf**.

12 On the potential advantages of using SIMM over Grid, see International Swaps and Derivatives Association, "Are you faced with Initial Margin Calculation Challenges?" (17 Oct 2019), online: **https://www.isda.org/a/3FWTE/Implementing-Initial-Margin-Model-vs.-Grid-17th-Oct.pdf**. Additionally, ISDA notes several other potential benefits of using SIMM, including providing greater ability for market participants to predict liquidity requirements, aiding in the fast resolution of margin disputes and resolution of calculation discrepancies, offering greater transparency, and being operationally simpler to deploy.

13 In some cases, transactions entered into prior to the implementation date can also be brought into scope where they are amended. There was concern that changes to replace LIBOR and other Interbank Offered Rates benchmarks would make many legacy transactions subject to the Rules. However, this has been alleviated since US regulators have proposes that transactions amended to replace such benchmark rates would not be drawn into scope. See ISDA Letter to US Prudential Regulators on Revised Margin Requirements" (9 Dec 2019), online: **https://www.isda.org/a/yUxTE/Final-ISDA_Margin-NPR-Comment-12.9.19.pdf**.

14 See **https://www.isda.org/a/0VtTE/Trade-lifecycle-events-List-8.27.19.pdf**.

15 For Haircuts, see "Margin requirements for non-centrally cleared derivatives" (Jul 2019) a page 26, online: **https://www.bis.org/bcbs/publ/d475.pdf**.

Therefore, it is important for managers to understand which jurisdiction's Rules apply to them. The general rule of thumb is that the Rules of the domicile of the SD with which the Fund is trading will apply.[16] For instance, for a US-based manager, with a Cayman-domiciled Fund trading with a US-based SD, the US Rules will apply. If this same fund is facing an EU SD, then EMIR would apply. There can also be situations where the Rules of more than one jurisdiction apply, and in such cases, cross-border guidance provided by ISDA has specified that the strictest Rules would be applied.[17] In other words, when in doubt, assume the stricter Rules apply.

TO WHOM DO THE RULES APPLY?

In the United States, the Rules are enforceable by regulators against Covered Swap Entities **("CSEs")** which are typically the SDs.[18] As mentioned above, funds are not directly subject to the Rules under US regulations but they will be impacted since their SDs are required to implement the Rules in their trading relationships with them. In other words, the SD will not transact with a fund that does not comply.

WHEN DO THE RULES APPLY TO A FUND?

1. Average Aggregate Notional Amount ("AANA") Of U-OTC

The Rules begin to apply to a fund once it has "material swaps exposure" which is defined as having an AANA above the thresholds set out in Figure 2 below. The applicable AANA level is determined by calculating the AANA of U-OTC derivatives for such fund over a prescribed period. Where such fund is consolidated with other funds or in an affiliated group, the AANA amounts are added together for such group for the purposes of calculating the AANA amount applicable to each such fund.

Each year, this assessment must be carried out, and if a fund is above the AANA threshold, it becomes subject to the Rules for the next phase of the implementation period. Phases 1-4 have already been implemented. Phases 5 was implemented in September 2021 and 6 is next: September 2022.

Following the Phase 6 implementation, Funds will need to calculate their AANA on an annual basis to see if they become/remain subject to the Rules in the future. Regular assessments will need to be carried out to see if a fund remains subject to or has become subject to the Rules.

16 A notable exception to this rule is in Europe, under EMIR, where an EU-based fund can be subject to direct regulation. Another exception is where the SD is registered as a swap dealer in more than one jurisdiction.

17 See International Swaps and Derivatives Association, "Guide to the Cross-border Application of US, EU and Japan Margin Rules for Non-cleared Derivatives" (Jan 2020), online: **https://www.isda.org/a/ohJTE/Guide-to-Cross-border-Application-of-US-EU-and-Japan-Margin-Rules-for-Non-cleared-Derivatives.pdf**.

18 Section 4s(e)(2)(B) of the Commodity Exchange Act in the United States directs the CFTC to impose margin requirements on SDs and Major Swap Participants ("MSPs") for which there is no Prudential Regulator. These entities are defined in the Rules as Covered Swap Entities ("CSEs"). Also, recall that in Europe, funds may also be directly subject to the Rules. Under EMIR, both Financial Counterparties ("FC"), including HFs and other alternative investment funds, and Non-Financial Counterparties ("NFC") such as payment service providers, are regulated by the new rules. The new rules for U-OTC apply to trades where either: 1) both parties are either EU-domiciled FCs or NFCs; or 2) one party is an EU-domiciled FC or NFC and the other party is a non-EU domiciled FC or NFC that would be an FC or NFC if it was established in the EU.

Figure 2. Implementation Dates Under US Rules[19]

Phase	Implementation Date	Determination Months	AANA Amount (USD)
Phase 1	September 16th	*passed*	*above 3 Trillion*
Phase 2	September 17th	*passed*	*above 2.25 Trillion*
Phase 3	September 18th	*passed*	*above 1.5 Trillion*
Phase 4	September 19th	*passed*	*above 0.75 Trillion*
Phase 5	September 21st	*passed*	*above 50 Billion*
Phase 6	September 22nd	*June, July, August 2022*	*above 8 Billion*

How to Calculate AANA

- AANA is calculated based on the average daily notional amount of U-OTC.
- Managers should include all outstanding U-OTC transactions. Do not include cleared OTC or listed derivatives. Please note that some U-OTC transactions must be included for AANA calculation, yet they are excluded from the IM requirements of the Rules (we will review this in the next section).
- Where positions are offsetting or netted, both sides are included in the calculation.
- Calculation performed at the fund level[20] provided that each fund is a distinct legal entity, and is not collateralized, guaranteed or supported by any other fund or the manager. Recall that AANA amounts must be aggregated for funds/entities which are part of a consolidated group.
- AANA is calculated for each business day of the month in the relevant determination period; for Phase 5, this is March, April, and May of 2020.
- All daily AANA numbers for the determination period are added together and then divided by the number of business days in such period.

AANA Determination Scenario:

- Fund has a portfolio of three U-OTC transactions, and each has a notional value of $10 billion on each business day of March, April, and May 2022.
- Another U-OTC transaction is added to the Fund’s portfolio on May 1st, 2022, and its notional value is also $10 billion on every business day in May 2022.
- Result: On each business day in March and April of 2022, the AANA is $ 30 billion (i.e., the three U-OTC transactions). On May 1st, the AANA is $40 billion as a 4th U-OTC transaction was added.
- Therefore, the daily average ANNA is calculated as follows:
- (22 x $30 billion + 22 x $30 billion + 21 x $40 billion)/(22+22+21) = $34.3 billion
- As such, this entity would be in-scope for Phase 6.

19 The calculation is performed at the principal level – the entity which is a party to the transaction, generally the Fund. For pension funds or asset owners making use of managed accounts, where multiple Managers manage a portfolio which is part of one legal entity, they would need to look at AANA on an aggregate basis across all their portfolio managers.

20 The calculation is performed at the principal level – the entity which is a party to the transaction, generally the Fund. For pension funds or asset owners making use of managed accounts, where multiple Managers manage a portfolio which is part of one legal entity, they would need to look at AANA on an aggregate basis across all their portfolio managers.

2. IM Is Only Exchanged Above A Certain Threshold

Point 1 above is the test to see if the Rules apply to a relationship, but parties only need to comply with the Rules when the IM requirement on U-OTC entered into after the phase-in date is greater than USD 50M (the "IM Threshold"). The IM Threshold is applied as between two direct trading counterparties and is consolidated at a group level. For a SD, the consolidated group means that we must look to relationships with all the SD's affiliates.

For funds, subject to what was explained in the AANA section above, Managers should look at the IM requirements (using Grid or SIMM methodology) of each of their funds separately. They should therefore add all the IM amounts which a given fund would have at a SD group to determine if it is above the IM Threshold.

If the result is that IM requirements are below 50M, then the exchange of IM will not be required with such SD. If the result yields a number above USD 50M, then IM must be exchanged in accordance with the Rules for that SD group.

"SIMM gets a lot of the headlines, but calculating SIMM is only one consideration."

3. IM Transactions Subject To The Rules – Types; And New vs. Legacy

As alluded to earlier, in calculating AANA, a manager must take into account all U-OTC transactions. With respect to the posting of IM, there are a number of U-OTC transactions which are excluded from the Rules (for instance, physically settled FX and certain options transactions are excluded).[21]

Moreover, as mentioned previously, the Rules only apply to U-OTC transactions entered into after the applicable phase-in date. Legacy U-OTC are not in scope, provided that an eligible lifecycle event has not occurred. This has a significant benefit as it will delay the application of the Rules to parties which have high IM amounts on legacy trades. Depending on the turnover of a manager's books, even if IM on legacy plus new transactions is above USD 50M, it may take months or years before they have turned the book and IM on new transactions is above USD 50M.

21 For a summary table on which transactions are in scope, see **https://www.isda.org/a/HHhME/ISDA-In-Scope-Products-Chart_UnclearedMargin_08Aug2019.pdf**.

OPERATIONAL CONSIDERATIONS

For many people, when they think of operational challenges with UMR, they immediately think of SIMM. As discussed, SIMM is the most popular method for calculating IM through a risk-based model, and the complexity of performing this calculation can seem like an onerous task. As a result, SIMM gets a lot of the headlines. However, calculating SIMM is only one consideration. For managers with funds subject to the Rules, there will be several operational hurdles that must be managed to achieve compliance.

COLLATERAL SEGREGATION MODELS

As discussed, the Rules require IM to be held in a segregated account at an unaffiliated third-party custodian. This means that the chosen custodian may not be affiliated with either of the U-OTC counterparties. This is an important consideration, as some custodians also have affiliate entities that are SDs. If a fund is trading with a SD counterparty who has a custodian entity, that custodian entity may not be chosen to hold the IM for that specific trading relationship. It would still be possible, however, for that custodian entity to be chosen to hold IM for all of the fund's other trading relationships.

There are two types of IM segregation models: Tri-Party Model and Third-Party Model. Managers will need to agree which model will be used with their SD and custodian.

1. Third Party Model

This is the traditional method for segregating collateral with which many managers are already familiar. In a third-party custody account, the collateral pledgor establishes one stand-alone account for each trading relationship. For each agreed collateral pledge, the pledgor must instruct the collateral to be moved into the account. For each return of collateral, the secured party must release the collateral to be returned from the account. In this model, the custodian only has the role of holding the collateral and acting on the instructions of the two parties. Any changes in the collateral posted must again be agreed to by both parties and authorized by the secured party before the custodian will allow the release. This model is operationally intensive as the SD and manager take an active role in determining eligibility, selecting and moving the collateral.

2. Tri-Party Model

This is a more automated and lower touch option. It delegates much of the collateral valuation, eligibility checks, and settlement function to the custodian. In this model, the collateral pledgor establishes a "long box" account of assets owned by the pledgor. Linked to this long box are several pledge accounts, one for each trading relationship. Each day, the parties determine the amount of collateral needed to satisfy the day's margin requirement. This amount is known as the required value, or "RQV." Through the daily margin call process, the RQV is agreed on between the parties. Both parties must then communicate that amount to the custodian. The custodian allocates the optimized eligible collateral from the long box to each pledge account. Daily wire movements are not needed, nor is consent for substitutions. This model can be more efficient but requires different connectivity than the traditional third-party model. This model also involves more fees paid to the custodian for additional services provided.

The tri-party model for segregation of regulatory IM was built based on the existing tri-party functionality that has existed for years in the repo world, so the basic concept was very familiar to SDs when the infrastructure for the first phases of UMR were being built, starting in 2016. Due to the increased efficiency, the tri-party model has been widely adopted by parties who were subject to UMR in Phases 1-4.

It is expected that as the scope of UMR extends more to the buy side in Phase 5 (just underway) and, soon, Phase 6, the Third-Party Model will be the more popular choice, due to the buy side's familiarity with this model. It is important for managers to keep in mind, however, that even if they choose the Third-Party Model for their posting of IM, their SD counterparty will be likely to use a tri-party model when posting IM to the fund. Since the tri-party model requires both parties to communicate the RQV to the custodian each day, managers will need to have a means of connecting to the custodian to communicate that number.

MARGIN APPROACH (IA AND IM)

The relationship between IA and IM is important to understand. Recall that IA is a requirement levied on funds by SDs based solely on the SDs discretion and credit appetite. The IA is not dictated by any regulation, but it is necessary for funds to meet this requirement in order to continue to trade with their SD counterparties. Even after funds become subject to UMR, it is not expected that the amount of additional margin required by SDs will decrease, even if the amount prescribed by the Rules is less than the IA charged by the SD. However, if the amount of IM prescribed by the Rules is above the IM Threshold (i.e., $50M) and is greater than the IA from the SDs, the greater of the two amounts will need to be satisfied. Further, if there is any IM requirement (greater than zero), that amount must be treated in the manner prescribed by the Rules as far as collateral type, haircut, and segregation. This relationship between IM and IA has yielded three standard approaches which may be elected by the parties in their credit support documentation:

1. Distinct Approach

In this approach, the flow of IM and the flow of IA are separate and distinct. Any IA requirement from the SD is paid to the SD in the manner agreed to by the parties. This may be comprised of any collateral agreed to between the parties and may be posted to the SD directly. Separately, the IM is calculated according to the Rules and any required collateral must be eligible collateral according to the Rules and held in a segregated account as prescribed by the Rules. Therefore, the IA and IM are both paid in their entirety. This approach has the benefit of simplicity, but the cost of “double-dipping” makes this approach untenable to most funds.

Example:

House Requirement (IA)	45M
IM requirement under Rules	60M
IM Threshold is USD	50M

Result: 10M in IM is subject to the Rules, above the 50M threshold, and must be sent to a segregated custody account.

35M in IA must be sent to the swap dealer.

A total of 45M must be posted in all.

2. Allocated Approach

In this approach, any IM requirement is posted to a segregated account in the form of eligible collateral as prescribed by the Rules. If the IA is less than the IM amount posted, the IA will be deemed to have been covered by the posting of IM. If the IA requirement is greater than the IM posted, the additional amount necessary to meet the IA requirement is allocated to the SD, according to the legacy IA process. This approach has the benefit of limiting the amount of collateral pledged to only the larger amount, however the operational complexity of splitting payments to two locations may be burdensome.

Example:

House Requirement (IA)	45M
IM requirement under Rules	60M
IM Threshold is USD	50M

Result: 10M in IM is subject to the Rules, above the 50M threshold, and must be sent to a segregated custody account.

An additional 35M in IA is also sent to the same segregated custody account.

A total of 45M must be posted in all.

3. Greater Of Approach

In this approach, a determination is made as to which requirement, the IA or the IM, is greater. The posting of the greater amount is deemed to satisfy both requirements. That amount, regardless of whether it is IA or IM, is then posted to the segregated account in a form of collateral as prescribed by the Rules. This approach is a happy medium between the other two approaches, in that it only requires that the larger amount be posted (rather than both amounts) and the operational complexity is limited since only one flow of collateral is necessary.

Example:

House Requirement (IA)	45M
IM requirement under Rules	60M
IM Threshold is USD	50M

Result: 10M in IM is subject to the Rules, above the 50M threshold, and must be sent to a segregated custody account.

An additional 35M in IA is also sent to the same segregated custody account.

A total of 45M must be posted in all.

The choice of Margin Approach is an important one for Managers to consider during their planning process. Since this choice is determined through bilateral negotiation between both SD and Fund, it is important for managers to implement processes and systems that are flexible enough to accommodate different approaches for their SDs.

COLLATERAL SELECTION AND MOVEMENT

Once margin calls are issued, received, considered, and responded to, the job of selecting and moving collateral must be done. As mentioned, this process can differ (even significantly) from the legacy process that Managers have become accustomed to for moving collateral for the VM process.

Permissible eligible collateral types for IM, as well as the haircuts for each collateral type, are defined in the Rules. This includes factors such as concentration or credit quality rules for certain collateral types (according to the European rules) as well as restrictions on securities issued by affiliates of the posting party (so-called “Wrong Way Risk”). From that universe of permissible collateral types, the specific ones that may be posted are defined in the agreement between the parties.

In a Third-Party Model structure, the posting party must determine which piece(s) of collateral to post, and the quantity of that collateral to post, considering the applicable eligibility and haircut rules. To minimize the financial and liquidity impact of posting this additional collateral, managers will want to select this collateral from available assets in the most optimal allocation possible. Furthermore, managers will want to implement systems and processes to automate the selection of this collateral to minimize the impact on operational resources. Following the collateral selection, the posting party must then initiate the movement of that collateral from the holding account into the third-party custody account. When later recalling this collateral, the posting party must send that instruction to the custodian, however the custodian will not return the collateral unless a release is granted from the secured party. Again, managers will want to automate these collateral movement instructions to the custodian to the extent possible, in order to maximize the efficiency of their operations.

In a Tri-Party Model structure, the collateral selection and movement process will differ. In this structure, it is the custodian’s responsibility to select the collateral type and quantity, in the most optimal configuration, based on the established eligibility and haircut schedule as well as a priority ladder provided by the posting party. This collateral will be automatically moved by the custodian from the posting party’s long box account to the applicable pledge account. If at any point, a more optimal collateral allocation becomes available, the custodian will reallocate the collateral posted between the long box and pledge account. Because the specifics of the pieces of collateral posted are the responsibility of the custodian, the only thing required from the posting and secured parties on any given day is an agreement on the RQV. The RQV must be communicated from both parties to the custodian each day. While a triparty setup can be a more operationally efficient process for moving collateral than the legacy third party process, it does require both parties to have connectivity to deliver the RQV to the

custodian each day. This is a new process that managers need to consider, as it was not necessary in the legacy VM collateral workflow.

LEGACY TRADES VS. NEW TRADES

The Rules only requires Funds to post IM on new transactions, entered into after the compliance date. However, managers may, at their option, include the fund's full population of legacy trades as well (trades that pre-date the compliance date). Managers may not, however, "cherry pick" only certain legacy trades to include, it's an all-or-nothing proposition. This leaves managers with two options:

1. Apply the Rules/IM requirements only to new transactions. As such, legacy trades would continue to exchange IA as they currently do, and only new transactions will be based on the Rules. This will require the manager to operate with a separate workflow for IA vs. IM (as well as different legal documents).

2. Apply the Rules/IM to all transactions. This can simplify operational processes but may result in greater margin requirements hence increasing margin drag on the portfolio.

THRESHOLD MONITORING

Firms whose AANA has surpassed the threshold for any phase will be subject to the Rules once the effective date of such phase has passed. However, if the amount of IM required falls below the IM Threshold, collateral need not be posted. This doesn't get managers off the hook, however.

The regulatory guidance on this point states that: "It is expected, however, that covered entities will act diligently when their exposures approach the threshold to ensure that the relevant arrangements needed are in place if the threshold is exceeded." This means that all documentation, accounts and operational processes need to be fully in place before the IM requirement crosses the IM Threshold. Further, managers must monitor where their fund's IM requirement is versus the IM Threshold so they can be prepared to move collateral as soon as it is necessary.

THRESHOLD AND MTA ALLOCATION

As mentioned previously, the IM Threshold is consolidated at the Group level. This means that affiliated legal entities must share the 50M threshold. The threshold amount may be allocated amongst those entities in any proportion, as long as the total threshold amount for all affiliated entities combined does not exceed 50M. Similarly, the Rules allow each legal entity to utilize a 500k minimum transfer amount ("MTA"); however, this amount must cover that entity's IA, IM, and VM margin calls. This can prove to be a very tricky proposition, particularly for funds covering separately managed accounts. Because of these considerations, for the purposes of threshold monitoring and margin call calculation, managers will require systems with enough flexibility to account for many different monitoring and calculation scenarios.

ORE XML AND SENSITIVITIES

Because SIMM is a risk-based model, its calculation is less straightforward than the Grid method. The process of calculating SIMM requires that the risk sensitivities in U-OTC portfolios be taken as inputs. Firms therefore must first calculate the delta and vega sensitivities in order to calculate SIMM. Since that task may be seen as a large lift for some managers, service providers have emerged who will calculate a manager's risk sensitivities for them. While this may be a good solution for many managers, the required data inputs to such sensitivities calculation process must also be considered. In many cases, managers must first aggregate their trade data in a format called ORE XML, which standardizes the data for each U-OTC trade type. Creating the ORE XML file, again, is a large effort for many managers. It's important to implement systems and processes to aggregate and create such files to ensure a smooth and accurate daily workflow to calculate the SIMM requirement for collateral movements each day.

Some U.S. managers have taken the position that they will rely on their SD to perform the SIMM calculation for both sides (pledgor and secured party). In these cases, the managers have decided to not independently calculate SIMM. This decision may eliminate some of the complexities in the generation and use of data files and workflows, but it eliminates the possibility to validate that the amount of margin posted and collected is accurate.

LEGAL DOCUMENTATION CHANGES

U-OTC trading which becomes subject to the Rules will require significant changes to legal documentation. In this section, we outline what the documentation looks like right now, how it will change, the key legal documents involved, their primary negotiation points, and the onboarding challenges that will be encountered in the process.

Before we proceed, it is important to note that global regulators require that parties only enter into new legal documentation once they have or are soon expected to cross the IM threshold. This means that a fund which has material swaps exposure (i.e., AANA above the thresholds) but which does not expect to cross the 50M IM threshold with any SD group does not need to redocument all of its U-OTC trading relationships. This was initially a big concern for the market and has since been alleviated.

Nevertheless, where a manager expects that its Fund(s) might cross the IM threshold, it should be mindful that it can take many months to negotiate documentation and implement new operational procedures. As such, for managers who believe their fund(s) will eventually come into scope, it is wise to begin redocumenting in the near term.

Another important consideration is that the legal documentation will vary both in content and in structure depending on the custodians selected and the Collateral Segregation Model agreed on with your SD. It is therefore important to get a good handle on the operational framework to engage in productive legal negotiations.

CURRENT LEGAL DOCUMENTATION FRAMEWORK

U-OTC trading is achieved in the market via the ISDA MA.[23] Since 1985, ISDA has been developing market standard documentation which has helped with the standardization and use of U-OTC. Although the ISDA MA and much of the other documents ISDA published are standard, negotiation does take place at various levels (for instance, in the schedule to the ISDA MA). The standardization helps as it creates a contractual framework for all market participants to negotiate within.

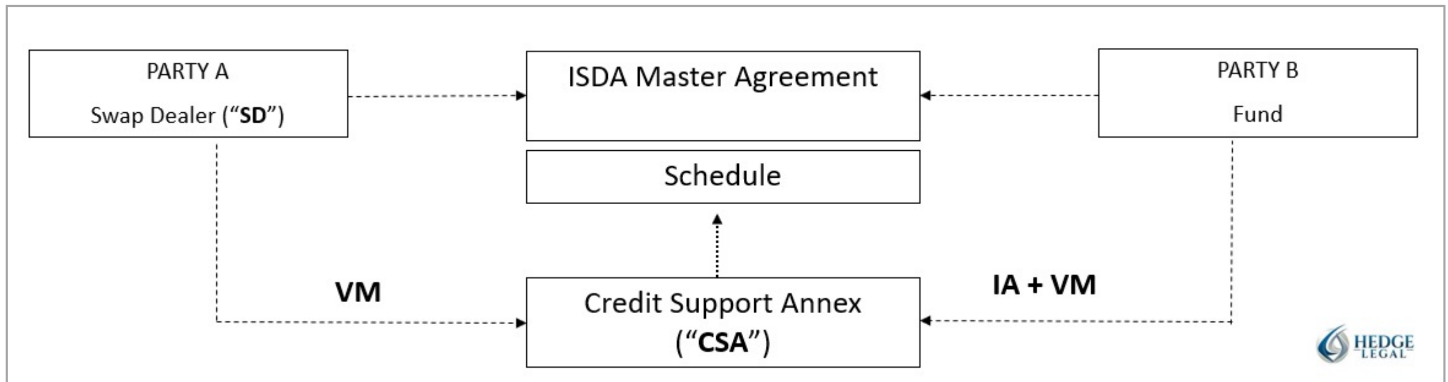
The exchange of margin (both VM and IA) for U-OTC occurs under the Credit Support Annex (“**CSA**”).[24] See Figure 3 below for pre-UMR document architecture.

> ***“It can take many months to negotiate documentation and implement new operational procedures.”***

23 Parties generally use the 2002 ISDA Master Agreement, although few still use the 1992 ISDA Master Agreement.

24 Many parties still use the 1994 New York Law Credit Support Annex (“1994 NY CSA”), although in recent years this has shifted to the 2016 NY Law Variation Margin CSA (“2016 VM CSA”). The 1994 NY CSA contains provisions for the transfer of both IA and VM. The 2016 VM CSA only includes provisions for VM, however the parties to new ISDA relationships routinely amend the 2016 VM CSA to include provisions for IA.

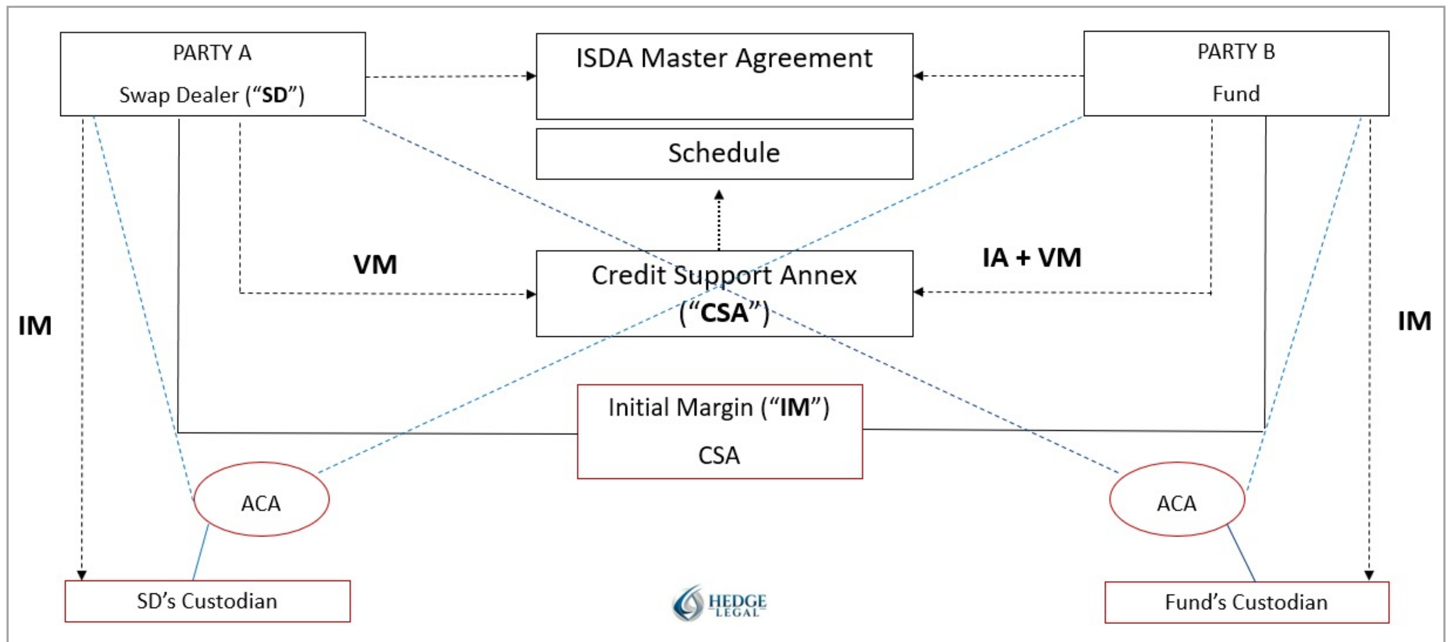
Figure 3. Pre-UMR Document Architecture



NEW LEGAL DOCUMENTATION FRAMEWORK

As noted previously, under the Rules, IM must be exchanged by both parties and held in segregated accounts. New documentation is required to create this new structure, primarily since holding collateral in segregated accounts involves the introduction of one or more third parties to act as custodian for the segregated IM accounts. Parties may choose to use the same custodian or appoint different ones, but in either case, two distinct custody agreements will be required, as well as separate account control agreements. Please see Figure 4 below for the new document architecture.

Figure 4. Post-UMR Document Architecture[25]



25 Please note the documentation architecture may be different depending on the Collateral Segregation Model selected, the Custodians chosen and the jurisdictions involved. This figure is intended to serve as a simplified general guide.

1. IM CSA - 2018 Credit Support Annex For Initial Margin (IM) (Security Interest – New York Law)

This is the new form of Credit Support Annex which ISDA has published for the exchange of IM. Please note that for arrangements under English Law, parties would use the 2018 Credit Support Deed For Initial Margin (IM) (Security Interest – English Law).

Key Features and Negotiation Points:

- This document will govern the exchange of IM.
- How IM will be held – using segregated accounts and custodians.
- Which Margin Approach will be used.
- How IM will be determined (SIMM model or Grid, etc.) and by whom (Calculation Agent).
- Establish the threshold for posting of IM
- Choice of applicable regimes – the Regime Table (i.e., the Rules of which jurisdictions will apply).
- Transfer timing, and minimum transfer amounts.
- Forms of collateral which may be delivered (i.e., what type of assets are eligible collateral).
- Resolving collateral disputes.
- Taking control of collateral (Notice of Exclusive Control).
- Custodian events – what events at the Custodian give rise to the other party to take the collateral from them. For instance, if custodian is failing to act in accordance with the ACA.

2. Custodian Agreement

If the fund does not already have a custodian agreement in place with a custodian who offers segregated IM services, then one will need to be put in place. It is important for managers to discuss capabilities with their custodian immediately. Although there are literally dozens of custodians offering segregation services, the custodians most used to date have been BNY Mellon, JPM Morgan, and State Street. Clearstream and Euroclear are also custodians, used primarily by European entities.

Key Features and Negotiation Points:

- As with any Custody Agreement there are several points which are important to negotiate.
- Custodian standard of care.
- Asset Control - Custodian segregation of assets/use of sub-custodians.
- Custodian liability/indemnification provisions.
- Representations and warranties.
- Termination without cause (i.e., length of time which custodian must provide services to you).
- Assignment and Amendment Rights.

3. Account Control Agreements ("ACAs")

For each pair of IM postings, a separate ACA will be needed and will have three parties to it:

(i) ACA when SD is posting IM. Parties: SD, SD's custodian, and fund.

(ii) ACA when fund is posting IM. Parties: fund, fund's Custodian and SD.

The ACA is necessary to enforce the security interest which each respective party has over the IM held by the other party's custodian. What the ACA effectively provides is that the custodian will hold IM, and upon instructions of the secured party (i.e., the party to which the IM has been "posted" to) specifying that the transferor (i.e., the party which has posted the collateral) has defaulted on its obligations under the ISDA MA, then the custodian shall deliver the IM to the secured party.

The idea here is for IM to be held in safekeeping by a third party, with the secured party only able to take the collateral once the other party has defaulted. This achieves the ultimate goal of posting collateral (i.e., protecting the creditor), but also protecting the collateral since, if the secured party goes bankrupt, the collateral held in the custody account does not become available to its other creditors and should be returned to the transferor.

Key Features And Negotiation Points:

- Establishing what events allow the secured party to take "control" of the account and instruct the custodian to deliver assets held in the segregated account to it (the "Notice of Exclusive Control" or "NEC").
- The secured party should only be permitted to provide a NEC when a termination event has occurred under the ISDA MA with all transactions being affected transactions.
- Establishing the events or conditions under which the transferor of collateral can take its collateral back. This should typically occur when the secured party has defaulted under the ISDA, all transactions are being terminated, and the transferor has no further amounts payable to the secured party.
- Operational details regarding timing of the above, and notice details will be included in the ACA.

ONBOARDING ISSUES/CHALLENGES – AML/KYC

As you can see from the document architecture above, the Rules add significant complexity to a fund's document architecture. It also brings new parties into the negotiation of some documents, meaning that up to four entities might be involved in negotiating one set of documentation between two parties. The ACAs can often take longer to negotiate than one would normally think. The reason for this is that not all SDs have active ACAs with all custodians. Through the first phases of UMR, and as more participants are drawn in, it is expected that as parties become more familiar with this arrangement and more agreements are negotiated, that the time to negotiate ACAs as well as custody agreements will decrease. Custodians may limit the room of negotiation they offer to funds.

Documentation teams at SDs will also face a pinch to negotiate additional documents which did not previously exist.

Beyond document negotiation, the onboarding process may also pose challenges for two main reasons:

(i) Custodians have increasingly lengthy AML/KYC requirements. It can take months to clear AML/KYC at a custodian with them requiring very detailed information about a fund, its manager, directors, officers, and investors.

(ii) Operational readiness. In integrating new clients, as well as offering new IM solutions to existing clients, custodians, SDs, and managers will have to coordinate new operational processes, systems, and reporting into their operational infrastructures.

For all the above reasons, it is critical that managers with in-scope funds get a head start in implementing new documentation and sorting out operational procedures. Managers who delay implementation may have difficulty getting documented in time and on well-negotiated and appropriate terms. Managers should factor in a least 4 months to complete negotiation and onboarding.

WHAT DO MANAGERS NEED TO DO?

In this section we seek to distill the most important action items for managers and provide a framework for them to approach the Rules going forward. At the end of this section we have provided a decision tree (see Figure 5).

1. ACT NOW - DETERMINE IF YOU ARE IN-SCOPE (AANA CALCULATIONS)

The first step for managers is to act now and calculate their AANA to see how they compare to the thresholds for the next phase of implementation. The AANA determination months for Phase 6 are upon us (March, April and May 2022 in Europe and for CFTC, June, July and August 2022 for US Prudential Regulators). It may prove difficult to calculate this with accuracy and compliance bottlenecks may form around deadlines set by regulation, making it difficult to get last-minute help and advice.

Managers will be required to make representations to their SDs shortly as to their status. If a manager is unable to make the representations, SDs may refuse to continue to trade.

2. CURRENT AND PROJECTED IM REQUIREMENTS

First, determine your current IM requirements with each SD group (using either Grid or SIMM). Next, consider how this might change in the future in accordance with projected Fund growth and changes in strategy depending on market developments. This will provide a good sense of whether a fund is close to the IM Threshold.

The use of a vendor specialized in margin and SIMM calculation can be helpful. These numbers are not always easy to obtain.

3. CHOOSE SERVICE PROVIDERS

If a manager determines that they are in scope, there are four categories of service providers that they should consider:

- **Technology provider** – to assist with AANA, IM calculations, and operations systems/tools.
- **Custodian** – necessary to hold IM.
- **Legal counsel** – to assist with document negotiation, provide advice and onboarding assistance.
- **Consultant** – optional, but useful to assist with overall implementation of the IM Rules (project management, technology and ops).

4. DISCLOSE YOUR STATUS AND CONSULT WITH YOUR SWAP DEALERS.

It is important to be in close contact with your SDs to disclose whether you are in scope, determine which UMR Rules apply, agree on a Collateral Segregation Model, agree on eligible collateral schedules, and put new legal documentation in place.

Funds will be required to disclose their status (i.e., AANA calculations) to their SDs either directly or via a market utility.[26]

26 See https://www.isda.org/2016/10/26/isda-regulatory-margin-self-disclosure-letter-2/

5. OPTIONS/ALTERNATIVES FOR MANAGERS TO MITIGATE OR AVOID THE IMPACT OF THE RULES

(i) Reducing AANA.

Managers may wish to reduce their total notional outstanding below the relevant thresholds so that they are not captured by the Rules:

a. Portfolio Compression – by minimizing the total number of offsetting contracts, a fund can reduce the notional value of their portfolio, thereby reducing their gross notional exposure. This may allow Funds to stay below key regulatory thresholds and potentially avoid the hassles that come with the Rules, such as the multiple workflows required for monitoring new and legacy trades.[27]

b. Shift away from U-OTC to increased use of futures or cleared OTC to reduce AANA.

c. Alter strategy more generally. For instance, a multi-strategy fund may consider removing some strategies that require intensive use of U-OTC.

Recall the key dates for determining AANA:

- March, April and May 2022 in Europe and for CFTC, June, July and August for US Prudential Regulators for Phase 6 (September 2022 Rules implementation)

If a fund is not over the AANA threshold for those months, then it is not subject to the Rules for the next phase in date. Every year the same analysis must be carried out.

(ii) Reduce IM.

If (i) above is not possible, and a manager must be subject to the Rules, they may wish to consider keeping IM at each SD group below the USD 50M threshold. There are multiple means through which this can be done:

a. Use more SDs so that the amount of IM at each SD remains below the 50M threshold. In doing so, at the time of executing a trade, a manager will need to consider not only the bid/ask (or price of the trade) but also consider the collateral implications such as whether a trade triggers IM to go above 50M with that SD.

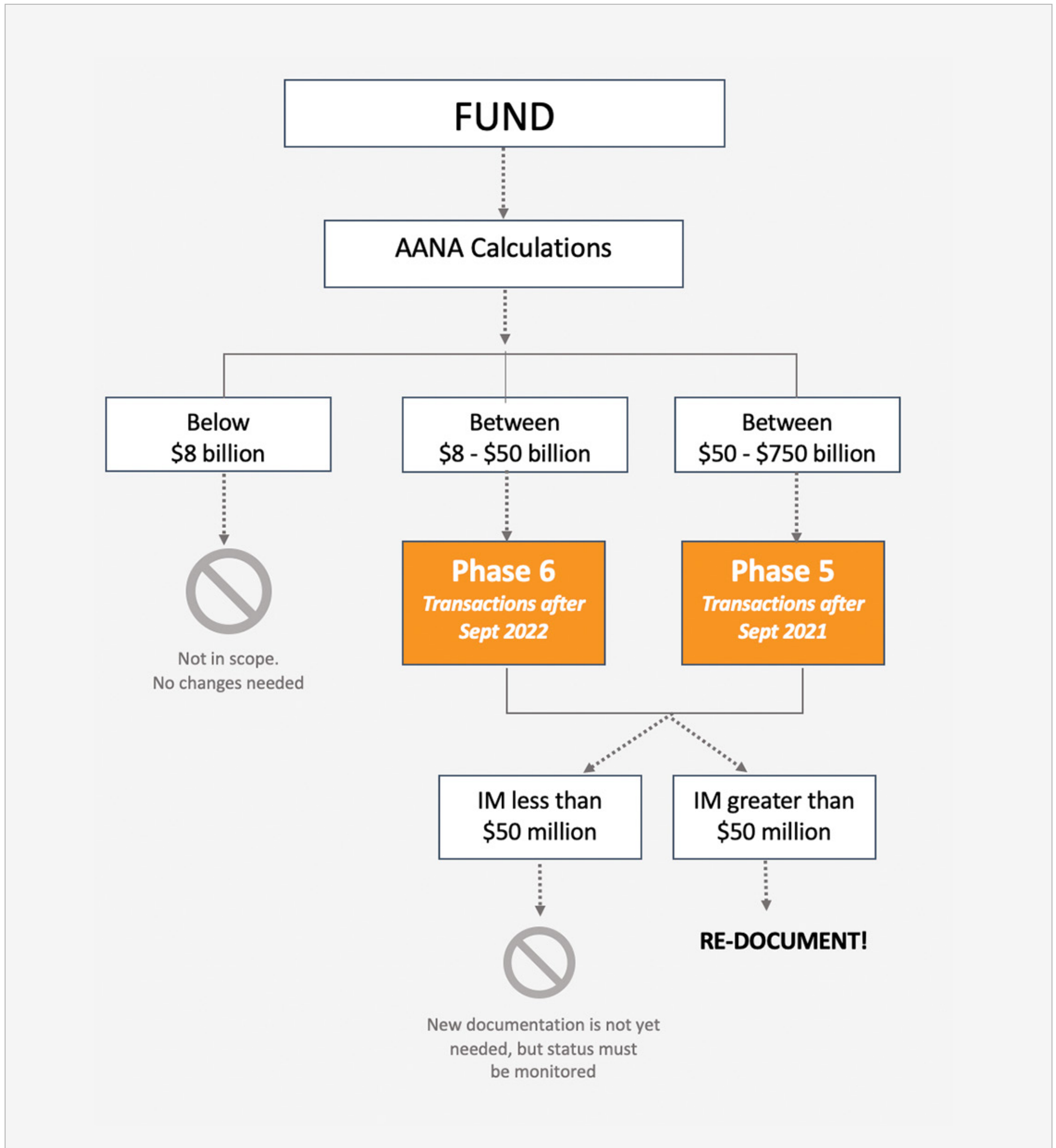
b. Shift away from U-OTC to increased use of futures or cleared OTC to reduce IM with an SD group.

(iii) Consolidate U-OTC Positions.

If a fund remains subject to the Rules, a manager could consolidate its U-OTC positions at fewer SDs so that there are fewer segregated collateral arrangements needed, reducing their legal and operational burden

27 See Risk.net, "Initial Margin" (2019) Initial Margin Special Report, online: https://www.risk.net/content-hub/initial-margin-special-report-2019-7250301 at 16.

Figure 5. Decision Tree



CONCLUSION

Managers have many decisions to make surrounding the new Rules for IM on U-OTC. We have laid out the decisions that managers will need to make in assessing whether their fund(s) will fall within the Rules and, if they come in scope of the Rules, how they need to prepare for the challenges ahead.

Funds falling within the Rules for IM on U-OTC will be required to make a series of comprehensive changes to their operations and legal agreements around U-OTC. The time to begin the dialogue and planning process around the Rules is now. If managers do not adequately prepare for the coming changes in a timely manner, their ability to execute their trading strategies may be seriously disrupted. ISDA has warned that unprepared in-scope counterparties may become unable to trade non-centrally cleared derivatives, limiting their options for both taking and hedging risk, and also potentially impacting liquidity in the derivatives markets more broadly.[28]

While the changes required to adapt to the Rules are numerous, managers can capitalize on this moment and turn it into an opportunity. Managers should view the current moment as a perfect time for overhauling their legal and operational strategies. By properly renegotiating the terms of their prior legal agreements, streamlining and integrating new technologies into their operational workflows, and forming new relationships with the service providers that will be required for compliance with the Rules, managers can transform a regulatory headache into a competitive advantage.

28 International Swaps and Derivatives Association and Securities Industry and Financial Markets Association, "Initial Margin for Non-Centrally Cleared Derivatives: Issues for 2019 and 2020" (Jul 2018) Discussion Paper, online: **https://www.isda.org/a/D6fEE/ISDA-SIFMA-Initial-Margin-Phase-in-White-Paper-July-2018.pdf** at 3-4..

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